In the

Supreme Court of the United States

OCTOBER TERM, 1974

74-

No. 1042

ERNST & ERNST, *Petitioner,*

vs.

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

vs.

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR PETITIONER

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INDEX

PAGE

Opinions below 1

Jurisdiction 2

Statute and rule involved 2

Questions presented 3

Statement of the case 4

Summary of argument 17

Argument:

I. Respondents may not predicate their causes of action against Petitioner for violations of Section 10(b) and Rule 10b-5 on allegations of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner 29

II. Petitioner exercised all due care and diligence in accordance with generally accepted auditing standards in conducting its audits of First Securities 60

III. Respondents' knowledge and conduct were such to cause their claims to be barred as a matter of law by the doctrine of equitable estoppel 78

IV. Respondents' causes of action are barred by the applicable statute of limitations because (i) Petitioner's alleged "negligent facilitation and implementation of fraud" cannot toll the statute of limitations and (ii) Respondents did not as a matter of law exercise the requisite due diligence in attempting to discover the fraud 91

Conclusion 115

Citations

Cases: PAGE

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972) 46, 60

Akron Presform Mold Co. v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974) 27, 106, 111

American Pipe & Construction Co. v. *Utah*, 414 U.S. 538 (1974) 100, 101

Arizona v. *Copper Queen Consolidated Mining Co.*, 233 U.S. 87 (1914) 80

Bailey v. *Glover*, 88 U.S. (21 Wall.) 342 (1875) 26, 27, 98, 99, 100, 106, 107, 110, 112

Birnbaum v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) 45, 51

Blue Chip Stamps v. *Manor Drug Stores*, ... U.S. ....., 43 U.S.L.W. 4707 (June 9, 1975) 19, 20, 23, 35, 36, 43, 45, 51, 54, 55, 56, 77, 80, 89

Bryan v. *United States*, 99 F.2d 549 (10th Cir. 1938), *cert. denied*, 305 U.S. 661 (1939) 102, 103

Burnett v. *New York Cent. R.R.*, 380 U.S. 424 (1965) 104, 105

Caddell v. *Goodbody & Co.*, [1973 Transfer Binder] C.C.H. Fed. Sec. L. Rep. ¶93,938 (N.D. Ala. 1972) 65

Cady, Roberts & Co., 40 SEC 907 (1961) 38

Cato v. *Southern Atlantic & Gulf Coast District of International Longshoremen's Association*, 364 F. Supp. 489 (S.D. Tex.), *aff'd sub nom.*, *Cato* v. *International Longshoreman's Association*, 485 F.2d 583 (5th Cir. 1973) 26, 101, 102

Chandler v. *O'Bryan*, 311 F. Supp. 1121 (W.D. Okla. 1969) 4

Cases: PAGE

Charney v. *Thomas*, 372 F.2d 97 (6th Cir. 1967) 94, 95

Chris-Craft Industries, Inc. v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973) 52, 53

City National Bank v. *Vanderboom*, 422 F.2d 221 (8th Cir. 1970) 53

Clegg v. *Conk*, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, ... U.S. ....., 43 U.S.L.W. 3659 (June 16, 1975) 19, 48

Cohen v. *Franchard Corp.*, 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973) 48

Cope v. *Anderson*, 331 U.S. 461 (1947) 93

Dale v. *Rosenfeld*, 229 F.2d 855 (2d Cir. 1956) 79

Daniels v. *Tearney*, 102 U.S. 415 (1880) 80

deHaas v. *Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970) 94

Deitrick v. *Greany*, 309 U.S. 190 (1940) 80

Detroit v. *Grinnell Corp.*, 495 F.2d 448 (2d Cir. 1974) 103

Dickerson v. *Colgrove*, 100 U.S. 578 (1880) 80

Dixon v. *United States*, 381 U.S. 68 (1965) 37

Douglass v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (9th Cir. 1971) 94, 110

Drexel v. *Berney*, 122 U.S. 241 (1887) 80

Ellis v. *Carter*, 291 F.2d 270 (9th Cir. 1961) 50

Escott v. *BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) 62

First National Bank v. *Cities Service Co.*, 391 U.S. 253 (1968) 70

Fischman v. *Raytheon Manufacturing Co.*, 188 F. 2d 783 (2d Cir. 1951) 45, 46

CASES: PAGE

Glus v. *Brooklyn Eastern District Terminal*, 359 U.S. 231 (1959) 80, 81, 101

Hecht v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970) 79

Herzfeld v. *Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974) 63

Hochfelder v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) 4, 13, 32, 33, 99, 102

Holmberg v. *Armbrecht*, 327 U.S. 392 (1946) 23, 27, 79, 98, 99, 101, 110

Hupp v. *Gray*, 500 F.2d 993 (7th Cir. 1974) 112, 113

Janigan v. *Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965) 94

J.I. Case Co. v. *Borak*, 377 U.S. 426 (1964) 33

Johnson v. *Railway Express Agency, Inc.*, ... U.S. ....., 43 U.S.L.W. 4623 (May 19, 1975) 93, 98

Kardon v. *National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) 45

Lanza v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) 19, 48, 49

Leather Manufacturers' National Bank v. *Morgan*, 117 U.S. 96 (1886) 24, 80, 81

List v. *Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965) 38

Mills v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970) 60

Mintz v. *Mathers Fund, Inc.*, 463 F.2d 495 (7th Cir. 1972) 23, 76

Moerman v. *Zipco, Inc.*, 302 F. Supp. 439 (E.D. N.Y. 1969) 43

CASES: PAGE

Moran v. *Paine, Webber, Jackson & Curtis*, 389 F.2d 242 (3d Cir. 1968), *aff'g* 279 F. Supp. 573 (W.D. Pa. 1967) 79

Moviecolor Ltd. v. *Eastman Kodak Co.*, 288 F.2d 80 (2d Cir. 1961) 106

Myzel v. *Fields*, 386 F.2d 718 (8th Cir.), *cert. denied*, 390 U.S. 951 (1968) 53, 94

Parrent v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972) 94, 95, 110

Powell v. *Radkins*, 506 F.2d 763 (5th Cir. 1975) 102

Public Service Co. v. *General Electric Co.*, 315 F.2d 306 (10th Cir. 1963) 103

Rawlings v. *Ray*, 312 U.S. 96 (1941) 93

Republic Technology Fund, Inc. v. *Lionel Corp.*, 483 F.2d 540 (2d Cir. 1973) 48

Richland v. *Crandall*, 262 F. Supp. 538 (S.D.N.Y. 1967) 38

Riley v. *United States*, 212 F.2d 692 (4th Cir. 1954) 106

Royal Air Properties, Inc. v. *Smith*, 312 F.2d 210 (9th Cir. 1962) 50, 78, 79

Sargent v. *Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974) 49, 94

SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) 39, 47, 50

SEC v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) 19, 47, 49, 50

SEC v. *First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973) 4, 12, 88, 107

SEC v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973) 4, 12, 88

CASES: PAGE

SEC v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972) 47

SEC v. *National Securities, Inc.*, 393 U.S. 453 (1969) 41

SEC v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973) 47

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) 46, 47, 54

Shemtob v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971) 19, 47

Smallwood v. *Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974) 49

Soley v. *The Star & Herald Co.*, 390 F.2d 364 (5th Cir. 1968) 4

Speed v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) 38

Stevens v. *Vowell*, 343 F.2d 374 (10th Cir. 1965) .. 49

Stone v. *Bank of Commerce*, 174 U.S. 412 (1899) 80

Straley v. *Universal Uranium and Milling Corp.*, 289 F.2d 370 (9th Cir. 1962) 79

Superintendent of Insurance v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971) 33, 60

Trussell v. *United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964) 36, 37, 38

UAW v. *Hoosier Cardinal Corp.*, 383 U.S. 696 (1966) 92, 93, 94

Ultramares Corp. v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931) 56, 57

CASES: PAGE

Union Mutual Life Insurance Co. v. *Wilkinson*, 80 U.S. (13 Wall.) 222 (1872) 80, 81

United States v. *Diamond Coal & Coke Co.*, 255 U.S. 323 (1921) 101

United States v. *Georgia-Pacific Co.*, 421 F.2d 92 (9th Cir. 1970) 89

United States v. *One 1961 Red Chevrolet Impala Sedan*, 457 F.2d 1353 (5th Cir. 1972) 106

United States v. *Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) 63

United States v. *Webber*, 396 F.2d 381 (3d Cir. 1968) 4

Vanderboom v. *Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970) 27, 53, 95, 110

Vohs v. *Dickson*, 495 F.2d 607 (5th Cir. 1974) 19, 49

Wessel v. *Buhler*, 437 F.2d 279 (9th Cir. 1971) 65

White v. *Abrams*, 495 F.2d 724 (9th Cir. 1974) 20, 50, 51, 52, 53

Zenith Radio Corp. v. *Hazeltine Research, Inc.*, 401 U.S. 321 (1971) 96

STATUTES AND RULES: PAGE

Civil Rights Act of 1870, §16, 42 U.S.C. §1981 (1970) 98

Civil Rights Act of 1964, §706, 42 U.S.C. §2000e-5 (1970) 98

Federal Employers' Liability Act, 45 U.S.C. §161 *et seq.* (1970) 104

Federal Farm Loan Act, §16, 12 U.S.C. §812 (1970) 79

Fed. R. Civ. P. 56(e) 70, 89

STATUTES AND RULES: PAGE

Investment Advisors Act of 1940, §206, 15 U.S.C. §80b-6 (1970) 39

Illinois Securities Law of 1953, Ill. Rev. Stat. ch. 121½, §137.12 (1973) 95

Illinois Securities Law of 1953, §13D, Ill. Rev. Stat. ch. 121½, §137.13D (1973) 26, 91, 92, 95

Labor Management Relations Act, §301, 29 U.S.C. §185 (1970) 92, 93

Railway Labor Act, 45 U.S.C. §161 *et seq.* (1970) .. 102

Securities Act of 1933, §11, 15 U.S.C. §77k (1970) 44, 45, 46

Securities Act of 1933, §12, 15 U.S.C. §77l (1970) 44, 93

Securities Act of 1933, §13, 15 U.S.C. §77m (1970) 44, 93

Securities Act of 1933, §15, 15 U.S.C. §77o (1970) 44

Securities Act of 1933, §17, 15 U.S.C. §77q (1970) 40

Securities Act of 1933, §22, 15 U.S.C. §77v (1970) 44

Securities Exchange Act of 1934, §9, 15 U.S.C. §78i (1970) 18, 42, 93

Securities Exchange Act of 1934, §10b, 15 U.S.C. §78j(b) (1970) .....
2, 3, 13, 14, 16, 17, 18, 19, 20, 23, 27, 29, 31, 32, 34, 35, 36, 37, 38, 39, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 51, 52, 53, 54, 55, 56, 60, 77, 78, 79, 80, 89, 92, 93, 94, 95, 99, 104, 105, 108, 112,

Securities Exchange Act of 1934, §12, 15 U.S.C. §78l (1970) 34

Securities Exchange Act of 1934, §13, 15 U.S.C. §78m (1970) 34

Securities Exchange Act of 1934, §14, 15 U.S.C. §78n (1970) 33, 34

STATUTES AND RULES: PAGE

Securities Exchange Act of 1934, §15, 15 U.S.C. §78o (1970) 34

Securities Exchange Act of 1934, §16, 15 U.S.C. §78p (1970) 93

Securities Exchange Act of 1934, §17, 15 U.S.C. §79q (1970) 33, 34, 53, 63, 87

Securities Exchange Act of 1934, §18, 15 U.S.C. §78r (1970) 18, 42, 93

Securities Exchange Act of 1934, §20, 15 U.S.C. §78t (1970) 18, 43

Securities Exchange Act of 1934, §21, 15 U.S.C. §78v (1970) 59

Securities Exchange Act of 1934, §27, 15 U.S.C. §78aa (1970) 13

Securities Exchange Act of 1934, §29, 15 U.S.C. §78cc (1970) 93

Securities Exchange Act Rule 10b-5, 17 C.F.R. §240.10b-5 (1974) .....
2, 3, 13, 14, 16, 17, 18, 19, 20, 27, 29, 31, 32, 34, 35, 36, 37, 38, 39, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50, 51, 52, 53, 54, 55, 56, 57, 60, 77, 78, 89, 92, 93, 94, 95, 99, 104, 105, 108, 112

Securities Exchange Act Rule 17a-5, 17 C.F.R. §240.17a-5 (1974) 63, 87

28 U.S.C. §1254(1) (1970) 2

48 Stat. 84 (1933) 93

48 Stat. 908 (1934) 93

52 Stat. 1076 (1938) 93

OTHER AUTHORITIES: PAGE

AICPA, *Audits of Brokers and Dealers in Securities* (1956) 64, 65

AICPA, *Audits of Brokers and Dealers in Securities* (1973) 65, 66, 74

AICPA, *Codification of Auditing Standards & Procedures* (1973) 74

AICPA Statement on Auditing Procedure No. 33 (1963) 65, 74

51 Am. Jur. 2d *Estoppel* §146 (1970) 106

American Law Institute, Federal Securities Code Tentative Draft Nos. 1-3 (1974) 31

2 Bromberg, *Securities Law: Fraud* 31

Bucklo, Scienter *and Rule 10b-5*, 67 Nw.U.L.Rev. 562 (1972) 53

CCH AICPA Prof. Stands. ET §52 (1974) 59

31 C.J.S. *Estoppel* §§108-110 (1961) 81, 82

Duncan, *Selected Bibliography Including Legislative History of the Securities & Exchange Commission & the Statute It Administers*, 28 Geo. Wash. L. Rev. 391 (1959) 39

Forester, *Rule 10b-5 Violations in the Ninth Circuit: "I Know It When I See It"*, 30 Business Lawyer 773 (1975) 51, 52

Freeman, *Administrative Procedures*, 22 Business Lawyer 891 (1967) 40

Garrett, *New Directions in Profesional Responsibility*, 29 Business Lawyer 7 (1974) 58

Hearings on H.R. 7852 & H.R. 8720, 73d Cong. 2d Sess. 115 (1934) 40

III Loss, *Securities Regulation* (2d ed. 1961) 37, 38, 43

OTHER AUTHORITIES: PAGE

Loss, *Summary Remarks*, 30 Business Lawyer 163 (1974) 38, 52

NASD Rules of Fair Practice Art. III, §27(c) ..10, 11

Note, 82 Harv.L.Rev. 938 (1969) 38

Note, 44 Yale L.J. 456 (1935) 43

Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding & Abetting, Conspiracy,* in Pari Delicto, *Indemnification, and Contribution,* 120 U. Pa. L. Rev. 597 (1972) 58

SEC Accounting Release No. 153 (*Touche Ross & Co.*) (February 25, 1974) 59

SEC Accounting Release No. 157 (*In re Arthur Andersen & Co.*) (July 8, 1975) 59

SEC Accounting Release No. 170 (*In re Tubber T. Okuda*) (January 27, 1975) 59

SEC Annual Report (1942) 41

SEC Form X-17A-5, 17 C.F.R. §249.617 (1974) 21, 63, 64, 86

SEC Regulation S-X, Rule 2.01, 17 C.F.R. §210.2-01 (1974) 59

SEC Securities Exchange Act Release No. 3230 (May 21, 1942) 40, 41

S. Rep. No. 792, 73d Cong. 2d Sess. 6 (1934) 40

Websters New International Dictionary (3d ed. 1961) 38

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Court of Appeals reversing the decision of the District Court and remanding these cases for trial (Petition for Certiorari, Appendix A, pp. 1a-34a) is reported at 503 F.2d 1100 (7th Cir. 1974). The opinion of the District Court granting summary judgment for the Petitioner (Petition for Certiorari, Appendix B, pp. 35a-40a) is unreported.*

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* The opinions will hereinafter be cited to the Petition for Certiorari as follows: Pet. for Cert. App. A la *et seq.*, App. B 35a *et seq.*

JURISDICTION

The judgment of the Court of Appeals was entered on August 30, 1974, and a timely Petition for Rehearing was denied on November 22, 1974. (Pet. for Cert. App. C 41a). A Petition for a Writ of Certiorari was filed on February 20, 1975 and granted on April 14, 1975. The jurisdiction of this Court rests on 28 U.S.C. §1254(1) (1970).

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1970):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5 (1974):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order

to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

QUESTIONS PRESENTED

1. Whether Respondents may predicate their causes of action against Petitioner for violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1970), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5 (1974), on allegations of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?

2. Whether Petitioner as a matter of law exercised all due care and diligence in accordance with generally accepted auditing standards in conducting its audits of First Securities?

3. Whether Respondents' knowledge and conduct was such to cause their claims to be barred as a matter of law by the doctrine of equitable estoppel?

4. Whether Respondents' causes of action are barred by the applicable statute of limitations because (i) Petitioner's alleged "negligent facilitation and implementation of fraud" cannot toll the statute of limitations and (ii) Respondents did not as a matter of law exercise the requisite due diligence in attempting to discover the alleged fraud?

STATEMENT OF THE CASE

Petitioner, Ernst & Ernst, seeks reversal of the decision of the Court of Appeals which reversed the decision of the District Court granting summary judgment for Petitioner and remanded these cases for trial.*

a. Respondents' Dealings with Nay.

Beginning in the early 1940's, Leston B. Nay ("Nay"), President of First Securities Company of Chicago ("First Securities"), a small brokerage firm in Chicago, Illinois, induced the seventeen Respondents, separately and at various times, to make certain "escrow" investments which ultimately aggregated $1,073,000. (463 F.2d at 983-984; A. 11; *Martin* 1st Am. Comp. 12). Nay was secretive about the details of the "escrow" with Respondents, but he allegedly told them that he had been helpful to a small-loan company which was required by law to maintain a cash "escrow"; that the "escrow" investment was perfectly safe and was maintained at the Continental Bank in Chicago

* Many of the background facts to these cases are set forth in *SEC* v. *First Securities Co.*, 463 F.2d 981, 983-985 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), a successful appeal by Respondents from a denial of their claims in the equitable receivership of First Securities Company of Chicago. *See also SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973) (relating to the classification of Respondents as "general creditors" and not "customers" in the receivership proceedings); *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) (affirming summary judgment for the Exchange in the present cases). In a motion for summary judgment, a court may take judicial notice of facts established in prior proceedings. *See, e.g., United States* v. *Webber*, 396 F.2d 381, 386 (3rd Cir. 1968); *Soley* v. *The Star & Herald Co.*, 390 F.2d 364, 367 (5th Cir. 1968); *Chandler* v. *O'Bryan*, 311 F. Supp. 1121, 1122-23 (W.D. Okla. 1969).

(the purported depository of the "escrow" funds); that, since it would yield a high rate of interest (initially twelve percent per annum, but later to be reduced to nine percent), it was a desirable investment and one into which he had invested his own and his wife's money; and that because of his past favors to the small-loan company, he was given the opportunity to offer "escrow" investments to selected persons. (463 F.2d at 983-984; A. 65-70, 89-92).

Respondents paid for the "escrow" investments by checks payable to Nay or to a bank for his account. (463 F.2d at 984). In receipt of Respondents' cash investments, Nay usually executed a handwritten document and sometimes gave his personal promissory note to Respondents. (463 F.2d at 984). All, or substantially all, of Nay's correspondence with the Respondents was written on letterhead stationery of First Securities. Some of the letterhead stationery included the words, "Leston B. Nay, President," on the upper left hand portion thereof. (463 F.2d at 984).

During the years following his receipt of money from the Respondents, interest in the amount of approximately $665,000 was paid to them by Nay in connection with the "escrow." (463 F.2d at 984; Answers to Interrogatory 95). Nay personally paid the interest on the "escrow" investments by his personal check and annually sent to Respondents IRS Form 1099 which showed that the payments of interest to them had been reported by Nay as a deduction on his personal income tax returns. (463 F.2d at 984). In connection with audits conducted by the Internal Revenue Service of Nay's individual income tax returns for the years 1956 and 1965, Nay sent Respondents letters asking them to verify the amount of his personal indebtedness to them and the amount of interest he had paid them during the years under audit. (463 F.2d at 984). Each

Respondent returned these letters marked and signed to indicate their concurrence with the amounts shown as received from Nay. (463 F. 2d at 984). Some Respondents referred to the "escrow" investments in their correspondence from time to time as being personal loans to Nay. (463 F. 2d at 984). Moreover, Nay indicated to several Respondents that at his death his estate would be liable for the "escrow" investments. (463 F.2d at 985).

On June 4, 1968, Nay murdered his wife and committed suicide, leaving a note which described First Securities as being bankrupt and the "escrow" investments as being spurious. (463 F.2d at 983; A. 396). There was no small-loan company, and all representations made to Respondents by Nay concerning the "escrow" were false. (463 F.2d at 983-984). Nay had converted their money to his own use immediately upon receipt. (A. 11).

b. First Securities' Accounting System and Petitioner's Audits Thereof.

First Securities was a small broker-dealer in securities, registered with the Securities and Exchange Commission ("SEC") and a member of the Midwest Stock Exchange ("Exchange") and the National Association of Securities Dealers, Inc. ("NASD"). (463 F.2d at 983). Nay had been a principal of First Securities since the 1940's, holding 92% of the ownership of the company. (463 F.2d at 983, A. 10, 30, 33-34). Petitioner, a firm of certified public accountants, audited First Securities annually commencing prior to 1946. (A. 17, 20, 103, 135).

At the time of Nay's death in June 1968, First Securities employed 10 salesmen and officers and 9 other employees. (A. 97). One of these officers, Roy E. Campbell, was continuously employed by First Securities from 1946 to 1968 as, at various times, Cashier, Assistant Secretary,

Secretary, Office Manager and a Director. (A. 95). During the entire period he was responsible for First Securities' books and records and accounting matters. (A. 95-96). Nay, as President, exercised over-all responsibility for the business and financial affairs of First Securities, but his only function with respect to First Securities' accounting or record keeping was to approve and endorse confirmation tickets containing information relating to customer transactions executed by one of the other salesmen. (A. 96). Nay and one or two of the other officers would divide the tickets evenly among them, but no officer would approve or endorse a ticket with respect to a transaction handled by himself. (A. 96-97). Nay took vacations regularly and in the same frequency as other officers of First Securities from 1946 until 1968 and, in addition, was away from the office for long weekends. (A. 96).

The incoming mail procedures of First Securities were substantially unchanged from 1946 until Nay's death. (A. 97-98). The mail would be picked up in bundles at the post office by one of the clerks and brought to First Securities where it would be sorted. (A. 98). Nay had no connection with this function and never picked up or sorted the mail. (A. 98). The mail was divided between envelopes addressed to First Securities and envelopes marked to the attention of individual employees. (A. 98). All mail in the latter category was placed on the desk of the person whose name appeared on the envelope, and that person would open it. (A. 98). Nay was the only individual at First Securities who specifically requested that no person other than himself open mail addressed to him personally or to his attention (Nay's "mail rule"), and when Nay was out of town, he left instructions with his secretary to hold his mail until he returned to the office. (463 F.2d at 985, A. 98-99). In

only one instance in the twenty-two years of Mr. Campbell's employment at First Securities can he recall that checks or securities were received in an envelope with Nay's name on it while Nay was away from the office. (A. 99). In that instance, securities which Mr. Campbell had been expecting from a customer in Colorado were received in an envelope addressed to Nay's attention. (A. 99). Campbell opened the envelope and recorded the receipt of the securities. (A. 99).

In connection with all transactions in which securities were purchased by or through First Securities, regular confirmation of purchase forms were sent to each customer, accompanied by a business reply envelope pre-addressed to First Securities for the purpose of providing an envelope in which customers could forward their checks to First Securities postage free. (A. 99). Substantially all customers used the pre-addressed envelopes to forward their checks to First Securities. (A. 99). The envelopes bore only the name of First Securities, were delivered directly to the office by a postman so that the postage due could be collected and came directly to the cashier's cage to be opened there. (A. 99-100). Upon receipt of checks in this manner, a receipt or acknowledgment was sent to the customer. (A. 100). In connection with every sale of a security by or through First Securities, a customer would receive a confirmation of sale form; in connection with the receipt for safekeeping of securities of a customer, the customer would sign and return to First Securities a printed safekeeping receipt form; regular statements of accounts were sent to customers of First Securities pursuant to NASD and SEC rules and regulations; and other additional forms were used for more specialized transactions. (A. 100).

All seventeen Respondents in these cases were brokerage customers of First Securities, who purchased and sold securities in over 600 transactions with or through the firm. (A. 36-61). As such, they received and used the envelopes and all or some of the above-described forms (depending on the extent and nature of their securities transactions) in the normal course of their brokerage accounts. (A. 100). The "escrow" transactions, on the other hand, were not in the form usual to dealings between customers and First Securities, nor was the escrow reflected in periodic accountings by First Securities to the Respondents. (463 F.2d at 984).

All customers of First Securities, including the Respondents, whose accounts contained long or short securities positions, cash positions other than zero, or open contractual commitments as of an annual audit date received a request from First Securities, initiated by Petitioner, for a written confirmation to be made directly to Petitioner as to the accuracy of the statements of their accounts with First Securities. (A. 107-108, 136, 138). No Respondent at any time informed Petitioner concerning the "escrow." (A. 108-109, 136, 138-139). Rather, various Respondents answered confirmation requests of Petitioner from 1961 through 1967 (confirmations prior to that date having been disposed of in the ordinary course of business according to Petitioner's established record retention policy) without reporting the "escrow" or complaining that their investments were not reflected in the confirmation requests. (A. 108-109, 136, 138-139).

In connection with all of Petitioner's audits of First Securities, Petitioner obtained a written statement from Nay and Mr. Campbell in compliance with applicable audit requirements as to the liabilities of First Securities, and none of these statements for the audit years 1960 to 1967 referred to the "escrow." (A. 109).

Aside from Petitioner's audits, between 1946 and 1968 the books, records and office procedures of First Securities were regularly examined by the SEC, the NASD, and the Exchange. (A. 100-101). In each instance, the examination resulted in approval of the systems and procedures of First Securities. (A. 101). On two or three occasions, the Exchange brought representatives of newly admitted member companies to the First Securities office so that Mr. Campbell could instruct those persons on the record keeping and various other systems designed to meet the Exchange's requirements. (A. 101). The procedures of First Securities with respect to correspondence of its salesmen, including Nay, were checked in the normal course of the above examinations, particularly in the examinations of the NASD, and at no time did any representative of the Exchange, the NASD, or the SEC indicate that such procedures were inadequate and in no examination report of the Exchange, the NASD, or the SEC was any comment ever made concerning the inadequacy of such procedures. (A. 101). At no time did any representative of the Exchange, the NASD or the SEC ever inquire into the system maintained at First Securities with respect to the opening of mail. (A. 101). In particular, First Securities was subject to examination by the NASD for compliance with NASD Rules of Fair Practice, including Section 27, and, according to the NASD's records and files, examinations of First Securities were conducted by District No. 8 examiners for the years 1944-46, 1949, 1954, 1956, 1959, 1962, 1964, and 1967. (A. 141-142). In none of the examinations was any serious apparent violation of any NASD Rule of Fair Practice, including Section 27(c)*, noted (A. 141-142).

* Article III, Section 27(c) of the NASD Rules of Fair Practice provides:

Petitioner had no knowledge of the escrow at any time prior to Nay's suicide in June 1968. (A. 110, 137, 140). At no time did anyone connected with Petitioner examine personal financial statements or tax returns of Nay, nor did Petitioner perform personal services for Nay individually. (A. 109-110, 136, 139). Petitioner had no knowledge of Nay's financial condition or obligations to any of the Respondents or of any of the transactions between Nay and any of the Respondents prior to June 1968. (A. 109-110, 136, 139). Petitioner had no correspondence with Respondents (other than by the confirmation requests) nor was Petitioner ever contacted in any respect by any person or entity concerning the "escrow." (A. 110, 136-137, 139-140). None of the Respondents at any time saw or obtained Petitioner's audit reports concerning First Securities or its financial statements. (A. 82-83). No Respondent contacted Petitioner prior to June 1968 with respect to First Securities or Nay, and no Respondent ever made inquiry to Petitioner, the Exchange, the SEC, the NASD, Continental Bank, or any financial institution concerning the escrow prior to May 1968. (A.

* (Continued)

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

In its initial receivership opinion, the Court of Appeals held that First Securities was not in compliance with this provision. (463 F.2d at 988), and Respondents charged Petitioner in their Complaint with the failure to discover that First Securities was not so in compliance. (A. 13-15). Both the District Court and Court of Appeals, however, properly held that Petitioner had no duty to audit for compliance with NASD rules. (Pet. for Cert. App. A 19a-23a).

88-89). No Respondent ever had any contact with anyone at First Securities other than Nay regarding the "escrow" or ever made any inquiry there regarding the "escrow." (A. 89-92).

Petitioner's fee for performing its audits of First Securities and issuing its opinion on its financial statements was $2,000 to $2,500 annually during the last ten years of the audits. (A. 193-194). The last audit was conducted as of October 31, 1967 and the report thereon issued on December 12, 1967. (A. 103). Petitioner's partners or supervisors in charge of its audits of First Securities dring the years were LeRoy E. Kist (1946 to 1952), Newell P. Crockett (1952 to 1957), and Jerry M. Hooker (1957 to 1967), all of whom provided affidavits in support of Petitioner's motion for summary judgment. (A. 103, 135, 138).

c. History of These Cases.

Immediately after Nay's suicide in June 1968, SEC receivership proceedings were commenced as to First Securities. (463 F.2d at 983). All Respondents except Leon S. Martin and L. Stanbridge Martin presented claims against First Securities in those proceedings. (463 F.2d at 983). Their "escrow" claims were ultimately allowed by the Court of Appeals in its opinion in *SEC* v. *First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), but the Respondents were subsequently placed in a lower class of claimants than the customers of First Securities. *SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973).

On February 19, 1971 all Respondents except Leon S. Martin and L. Stanbridge Martin filed their initial complaint against Petitioner and against the

Exchange in the United States District Court for the Northern District of Illinois, Eastern Division. (A. 1). On May 18, 1971 the Martins filed their substantially identical, initial complaint against Petitioner and against the Exchange in the same court.* (A. 1). On October 12, 1971 Respondents jointly filed a First Amended Complaint in two counts. (A. 1, 3). The First Count charged that the Exchange aided and abetted Nay's fraud on the Respondents and that Nay's conduct in connection with the "escrow" investments was in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. 78j(b) (1970), and Rule 10b-5, 17 C.F.R. §240.10b-5 (1974) ("Rule 10b-5"), thereunder.** (A. 3-10). The Second Count charged that Petitioner Ernst & Ernst aided and abetted the same fraud perpetrated by Nay. (A. 10-15). The basis for federal jurisdiction for both counts was Section 27 of the 1934 Act, 15 U.S.C. §78aa (1970). (A. 3, 10).

Respondents' claims against Petitioner allege that Respondents were persuaded by Nay to invest funds in the "escrow" investments and that Nay converted such funds to his own use in violation of Section 10(b) and Rule 10b-5.

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* The two cases were treated in the District Court as if they were consolidated; all pleadings and other filings were made as to both cases and Petitioner's motion for summary judgment and the ruling thereon by the District Court applied to both cases. The appeals from the judgment of the District Court were consolidated pursuant to stipulation of the parties by order of the Court of Appeals on November 15, 1973.

** The Exchange answered the First Amended Complaint and filed a motion for summary judgment which was granted by the District Court on October 3, 1972 and affirmed by the Court of Appeals, *sub nom. Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

(A. 10-11). Petitioner is charged with aiding and abetting Nay's fraud by negligently failing to exercise proper or appropriate auditing procedures in the course of its audits. (A. 12-15). This charge of negligence hinges on Petitioner's alleged failure to make adequate and proper inquiry which Respondents allege would have resulted in discovery of the facts that Nay took no regular vacations and did not permit anyone but himself to open his mail. (A. 13). Respondents contend that discovery of these facts should have caused Petitioner to conclude that First Securities lacked proper internal accounting control and that Petitioner should have reported such conclusion on a questionnaire which it was required to file with the Exchange. (A. 15). Respondents, who allege that they relied on Nay's membership in the Exchange, charge that Petitioner's failure to report the alleged deficiency in First Securities' internal accounting control to the Exchange, constituted aiding and abetting of Nay's violation of Section 10(b) and Rule 10b-5. (A.10-15). Respondents do not allege that Petitioner committed, or had knowledge of, any deliberate or intentional fraud or reckless or willful conduct. (A. 81, 85-86).

After filing their First Amended Complaint, Respondents examined all of Petitioner's documents relating to its audits of First Securities and took the deposition of Jerry M. Hooker, a partner with Petitioner. (A. 178-230). Petitioner answered the First Amended Complaint and on December 11, 1972 filed its motion for summary judgment which is supported by the pleadings and Respondents' answers and supplemental answers to Petitioner's interrogatories. (A. 2, 92-94). In addition, Petitioner filed in support of its motion the affidavit of Roy E. Campbell; the affidavits of Jerry M. Hooker, Newell P. Crockett, and LeRoy E. Kist; the affidavit of John F. Walsh,

a certified public accountant with the accounting firm of Haskins & Sells; and the affidavit of John Ahern, Assistant Director of District No. 8 of the NASD. (A. 95-153). Thereafter, Respondents reexamined all of Petitioner's documents relating to its audits of First Securities, took the depositions of Petitioner's affiants, Messrs. Crockett, Kist, Ahern and Walsh, and took a second deposition of Mr. Hooker. (A. 231-392). Respondents then filed in opposition to Petitioner's motion the affidavits of Gerhard Mayer and Fred J. Duncombe, two retired certified public accountants, and the affidavit of Michael K. Garst, a retired national bank examiner. (A. 168-176).

On August 1, 1973, the District Court granted the motion for summary judgment and entered judgment for Petitioner in these cases. (Pet. for Cert. App. B 40a). Although Petitioner argued before the District Court that it could not be charged with aiding and abetting Nay's fraud since it had no knowledge of and did not participate in or affirmatively aid such fraud, the District Court found that Petitioner could be held liable "for any negligence in auditing First Securities Company. . . ." (Pet. for Cert. App. B 39a-40a). The District Court's decision granting summary judgment rested on the following three alternative grounds advanced by Petitioner:

1. That Petitioner as a matter of law performed its auditing duties properly since its affidavits showed that Petitioner audited First Securities in accordance with generally accepted auditing standards, and since Respondents' affidavits failed to provide any competent evidence to the contrary. (Pet. for Cert. App. B. 38a-39a).

2. That the Respondents were estopped as a matter of law from bringing their cause of action against Peti-

tioner since they had failed to report the "escrow" transactions to anyone, particularly when requested by Petitioner to confirm their accounts. (Pet. for Cert. App. B 37a).

3. That the applicable three year statute of limitations barred Respondents' cause of action and was not tolled by the doctrine of fraudulent concealment since (i) only Nay or First Securities and not Petitioner had fraudulently concealed Respondents' causes of action and (ii) the Respondents had not exercised due diligence or care to discover Petitioner's alleged negligence. (Pet. for Cert. App. B 36a).

d. The Court of Appeals Opinion.

On August 30, 1974 the Court of Appeals reversed summary judgment for Petitioner and remanded these cases to the District Court for trial. In so deciding, the Court of Appeals held:

1. That a cause of action for aiding and abetting solely by inaction may be maintained under Section 10(b) of the 1934 Act and Rule 10b-5 by a showing:

> that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure. (Pet. for Cert. App. A 4a).

2. That there are genuine issues of material fact to be decided at trial whether Petitioner breached such duty of disclosure, namely, "(1) whether Nay's 'mail rule' constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether [Petitioner] failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control." (Pet. for Cert. App. A 18a).

3. That whether the Respondents are barred by the doctrine of equitable estoppel because they "knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be properly decided by the fact finder." (Pet. for Cert. App. A 31a-32a).

4. That the applicable three-year statute of limitations could be tolled by Petitioner's alleged "negligent facilitation and implementation of Nay's fraud" and that whether the Respondents "knew or in the exercise of due diligence should have known of Nay's fraud is . . . an issue properly to be decided at a trial." (Pet. for Cert. App. A 34a).

SUMMARY OF ARGUMENT

I. Respondents have failed to state a cause of action under Section 10(b) and Rule 10b-5 against Petitioner because they have alleged only (and have conceded that they can only attempt to show) that Petitioner was negligent in auditing First Securities. They have failed to allege or show any deliberate or intentional fraud or reckless or willful conduct, or knowledge of such fraud or conduct, on the part of Petitioner. The Court of Appeals, in reversing the District Court's summary judgment on these facts, has thus adopted a negligence standard of liability under Rule 10b-5. This was a fundamental error, since *scienter* (actual knowledge, or reckless disregard, of fraudulent conduct) is a requisite element to a private damage action under Section 10(b) and Rule 10b-5, required by their language, their legislative and regulatory

histories, their role in the securities laws, the majority of Courts of Appeals' holdings, and strong policy considerations.

The language of Section 10(b) and Rule 10b-5 requires proof of *scienter*. A cause of action for negligence cannot be stated under any of the three clauses of Rule 10b-5. The language of subsections (1) and (3) of the rule proscribe only fraudulent conduct, and although the language of Rule 10b-5(2) is ambiguous, it must also be interpreted to preclude a cause of action in the absence of *scienter*. A contrary interpretation would cause the SEC to exceed its authority under Section 10(b) to prohibit "any manipulative or deceptive device or contrivance." The proper interpretation of Rule 10b-5 is that it does not prohibit three distinct types of conduct, but one type of conduct—fraudulent conduct, not mere negligence, thus requiring *scienter*.

The legislative and regulatory histories of the statute and rule also require proof of *scienter*. There is no evidence in the legislative history of Section 10(b) that Congress intended that a rule could be promulgated thereunder which would be a general prohibition against negligence in connection with the purchase or sale of securities. The regulatory history of Rule 10b-5 clearly indicates that at the time of its enactment the purpose of Rule 10b-5 was to broaden the authority of the SEC to combat fraud.

The overall scheme of the 1934 as well as the 1933 Act requires proof of *scienter*. Each of the express liability provisions of the 1934 Act (Sections 9, 18, 20) has specific language which prevents liability for mere negligent behavior. If the scope of Section 10(b) and Rule 10b-5 is extended to include negligent conduct without proof of *scienter*, the express liability provisions of the 1934 Act will be rendered surplusage. This is contrary to

the recent admonition of this Court in *Blue Chip Stamps* v. *Manor Drug Stores*, ... U.S. ....., 43 U.S.L.W. 4707, 4711 (June 9, 1975), that the implied cause of action under Section 10(b) and Rule 10b-5 should not exceed the bounds specifically delineated by Congress for the express causes of action of the 1934 Act. Moreover, all of the express liability provisions of the 1933 Act, although they explicitly allow a plaintiff to proceed against a defendant for negligent conduct, have specific venue, costs, and statute of limitations provisions applicable thereto. If private parties are able to proceed under Section 10(b) and Rule 10b-5 for negligence, they will be able to circumvent these explicit Congressional limitations.

The vast majority of the cases decided by the Court of Appeals have held that *scienter* is requisite to a private cause of action for damages brought under Section 10(b) and Rule 10b-5. This doctrine is particularly well established in the Second Circuit. *See Shemtob* v. *Shearson, Hammil & Co.*, 448 F.2d 442 (2nd Cir. 1971); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). The Tenth, Sixth and Fifth Circuits have all held that a private cause of action for damages under Section 10(b) and Rule 10b-5 may not be stated if only negligence is alleged, and the Sixth Circuit has similarly held with respect to SEC injunctive actions. *See, e.g., Clegg* v. *Conk*, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, ... U.S. ....., 43 U.S.L.W. 3659 (June 16, 1975); *Vohs* v. *Dickson*, 495 F.2d 607 (5th Cir. 1974); *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). The only holding outside of the Seventh Circuit that a private cause of action for damages may be stated without alleging *scienter* is that of the Ninth Circuit which has instituted

a "flexible duty standard." *See White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974). This standard is repugnant to the teaching of this Court in *Blue Chip Stamps, supra* at 7417, which rejects a shifting, highly fact-oriented approach to liability under Section 10(b) and Rule 10b-5.

Moreover, strong policy considerations require a *scienter* standard. As stated in *Blue Chip Stamps, supra* at 7412, litigation under Rule 10b-5 presents a particular danger of vexatiousness because the settlement value of a groundless claim may be high to a plaintiff and because difficult problems of proof may preclude summary judgment. This reasoning is similarly applicable to the issue presently before this Court. No policy consideration dictates that this Court establish a new liability for negligence for accountants under the securities laws without basis in the common law.

Further, the establishment of a negligence standard for liability under Section 10(b) and Rule 10b-5 is particularly inappropriate where, as in the instant cases, the defendant is a professional charged merely with aiding and abetting. A professional such as an accountant or lawyer who is not charged as a fraudulent wrongdoer is only a secondary target; the primary wrongdoer remains liable. The accountant receives only a fee for his services, so that the potential liability for his negligence is wholly disproportionate to the fruits of his participation. In addition, professional conduct is regulated in general by professional standards and authorities and in particular in the securities area by SEC injunctive actions and disciplinary procedures under SEC practice Rule 2(e).

II. Even if *scienter* were not a requisite element to Rule 10b-5 actions, the undisputed facts demonstrate that

Petitioner was not negligent and that it exercised all due care in accordance with generally accepted auditing standards in its audits of First Securities. The Court of Appeals misapprehended and misconstrued the record in these cases by failing to recognize that the affidavits of Petitioner are totally uncontroverted by any evidence submitted by Respondents, and its holding does serious violence to the device of summary judgment.

The measure of Petitioner's conduct with respect to its audits was the generally accepted auditing standards prevailing at the time of such audits. The Court of Appeals so held, and Respondents have so conceded. In addition, no precedent of this Court or of the lower courts holds otherwise. Such generally accepted auditing standards are incorporated into Form X-17A-5, promulgated by the SEC and in response to which Petitioner reported on the financial condition of First Securities. They are set forth in pronouncements of the American Institute of Certified Public Accountants, which make clear that the auditor's function is not to discover fraud or irregularities of a firm and that Petitioner can only be liable for its alleged failure to detect Nay's "mail rule" if Petitioner failed to comply with generally accepted auditing standards.

Petitioner's affidavits, presented in support of its motion for summary judgment and uncontroverted by any competent evidence on the part of Respondents, demonstrate that the Court of Appeals has strained beyond all reasonable bounds to find issues of fact. Petitioner submitted the affidavits of two certified public accountants, expert in the auditing of securities brokers and dealers, each of whom had fully reviewed all records and documents relating to Petitioner's audits of First Securities.

Both of Petitioner's affiants, John R. Walsh of Haskins & Sells, and Jerry M. Hooker of Petitioner, state, based on their review and their substantial expertise in broker-dealer audits, that Petitioner's audits of First Securities were conducted in accordance with generally accepted auditing standards regardless of inquiry into the handling of mail addressed to Nay. In answer, Respondents submitted the affidavits of a national bank examiner and two retired certified public accountants, none of whom had reviewed Petitioner's audit workpapers or documents or had any knowledge of the First Securities' audits. The affidavit of the national bank examiner, moreover, evidences no familiarity with generally accepted auditing standards and fails to comment on whether Petitioner met generally accepted auditing standards, and the affidavits of the two retired certified public accountants are without foundation and fail to express an opinion on the *critical issue:* whether Petitioner met generally accepted auditing standards in its audits.

Moreover, the uncontroverted evidence as set forth by Petitioner's affiants is that Nay's "mail rule" was not a material inadequacy in First Securities' system of internal accounting control. The purpose of an auditor's investigation into internal accounting control is to provide reasonable assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and adequate internal accounting control does not give any absolute assurance against fraud. Petitioner's affiants state, based on their review of Petitioner's audit documents, workpapers, and other records, and specifically assuming the existence of Nay's "mail rule," that Petitioner's audits of First Securities were conducted in full accordance with generally accepted auditing standards and that the alleged "mail rule" was not a material inadequacy in First Securities' system of internal accounting control. Respondents' affiants state only that, if in the course of an audit of a brokerage firm they would have discovered a "mail rule," they would have considered it an irregularity. These affidavits express only the personal opinions of the affiants, are not based on a review of Petitioner's audit documents, and do not state whether the *system* of internal accounting control at First Securities was adequate to support an accountant's expression of opinion. They wholly fail to measure Petitioner's conduct against generally accepted auditing standards.

The Court of Appeals' effort in finding issues of fact where none exist, and its forcing a useless trial, demonstrates the reluctance of that court to utilize the summary judgment device. The Court of Appeals violated its own announced standards (*Mintz* v. *Mathers Fund, Inc.*, 463 F.2d 495, 498 (7th Cir. 1972)) and acted in derogation of the recently expressed concern of this Court in *Blue Chip Stamps, supra* at 4713, as to vexatious litigation in securities law cases. This Court should reaffirm the utility of the summary judgment device in the Seventh Circuit.

III. Respondents' knowledge and inconsistent conduct with respect to their "escrow" investments bar their claims against Petitioner as a matter of law.

Although not in issue here, the Court of Appeals held that estoppel is an available defense to this action, and Respondents so concede. Moreover, a consistent line of Courts of Appeals' cases so hold, and this Court's cases indicate that this doctrine is one of the "historic principles of equity," which are applicable to causes of actions implied under Congressionally created statutes such as Section 10(b). *Holmberg* v. *Armbrecht*, 327 U.S. 392, 395 (1946).

The doctrine of equitable estoppel requires consistency of conduct, when inconsistency would accord substantial injury to the other party. Its elements are set forth in *Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96 (1886). They include: (a) knowledge, actual or constructive, by the party to be estopped of the true facts: (b) the course of conduct by the party to be estopped which amounts to a material failure to disclose or represent such true facts: and (c) justifiable reliance by the party claiming the estoppel upon the conduct of the party to be estopped, resulting in injury, detriment or prejudice to the party claiming the estoppel.

Respondents are equitably estopped as a matter of law because their entire course of dealing with Nay, First Securities and Petitioner demonstrates that they permitted their "escrow" investments to be handled outside the books and records of First Securities. They cannot now contend that such transactions should have been recorded as liabilities of First Securities for which Petitioner can be liable because it did not discover them.

Mr. Campbell, the principal accounting employee of First Securities from 1946 until 1968, states in his affidavit that all Respondents received confirmation of purchase or sale forms, regular statements, pre-addressed envelopes, and other forms from First Securities with respect to their regular First Securities' brokerage accounts, through which Respondents engaged in hundreds of transactions. Nevertheless, none of Respondents at any time complained to First Securities or to Petitioner that they did not receive First Securities' confirmation of transaction forms, regular statements or delivery receipts with respect to their "escrow" investments. Moreover, Petitioner's supervisors

or partners in charge of its audits of First Securities from 1946 to 1967 state that all Respondents whose accounts reflected a securities or cash position or an open contractual commitment on an annual audit date were sent a request by First Securities, mailed by Petitioner, for written confirmation to be made as to the accuracy of their accounts as reflected on First Securities' records. None of the Respondents ever informed Petitioner that their securities positions, account balances, or statements of open contractual commitments, which never reflected any transactions or positions with respect to the "escrow" investments, were incorrectly reflected on the books and records of First Securities or that, with respect to such investments, they were dealing with Nay personally.

The facts concerning Respondents' dealings with Nay set forth at pp. 4-6 of the Statement of the Case further establish the estoppel. Such dealings, direct and personal and on a continuous basis with Nay, make clear that (i) they knew or should have known that they were dealing with Nay personally, (ii) that the "escrow" investments were nowhere reflected in the books and records of First Securities, and (iii) that no one else at First Securities nor Petitioner knew of the "escrow" investments. All of these estoppel facts are totally uncontroverted by Respondents, and this Court should not reject this opportunity to reaffirm summary judgment principles.

The other elements of the doctrine of equitable estoppel, including Respondents' obligation to inform someone of their extra-record transactions and the ensuing prejudice to Petitioner from their failure, are clearly present as a matter of law in these cases. Respondents are therefore equitably estopped as a matter of law from their causes of action.

IV. The only issue before this Court with respect to the statute of limitations is whether the applicable time period was tolled by the federal doctrine of fraudulent concealment. Respondents have at no time raised any issue as to which statute of limitations controls their causes of action and when their causes of action accrued. Although these issues are not now before this Court, it is clear that the applicable statute of limitations is the three year bar of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13 D, and that Respondents' causes of action accrued more than three years before they filed their initial complaints in these cases.

Respondents may not rely on Petitioner's alleged "negligent facilitation and implementation" of fraud to toll the statute of limitations. Petitioner is not charged with any deliberate or intentional fraud or reckless or willful conduct or with knowledge of any such fraud or conduct. The opinions of this Court clearly indicate that the federal doctrine of fraudulent concealment is available only when the party who seeks to raise the bar of the statute of limitations committed or had knowledge of an act of fraud or of fraudulent concealment. *See Bailey* v. *Glover* 88 U.S. (21 Wall.) 342 (1875); *Cato* v. *Southern Atlantic & Gulf Coast District of International Longshoreman's Association,* 364 F. Supp. 489 (S.D. Tex. 1973), *aff'd. sub. nom. Cato* v. *International Longshoremen's Association,* 485 F.2d 583 (5th Cir. 1973).

The policy underlying statutes of limitations is to give defendants notice of stale claims within a reasonable period of time. The primary policy underlying the doctrine of fraudulent concealment is to discourage parties from committing acts of fraud or fraudulent concealment. *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342 (1875). This policy is not advanced unless the party against whom the doctrine of fraudulent concealment is invoked committed or had knowledge of an act of fraud or fraudulent concealment.

Moreover, limiting the application of the doctrine of fraudulent concealment to when the defendant has engaged in an act of fraud or fraudulent concealment is entirely consistent with the Congressional intent and the purpose and policy of Section 10(b) and Rule 10b-5. Strong policy considerations demand that the negligence of an accountant should not warrant the invariable tolling of a statute of limitations when, by happenstance, a potential plaintiff is injured by another's continuing fraud and, by further happenstance, that fraud involves a security.

Moreover, Respondents' causes of action are barred by the applicable statute of limitations because Respondents did not, as a matter of law, exercise due diligence in attempting to discover the fraud. This Court and the Courts of Appeals have repeatedly held that a plaintiff may rely on the doctrine of fraudulent concealment only as long as he remains in ignorance of the cause of action without any fault or want of diligence. *See Holmberg* v. *Armbrecht,* 327 U.S. 392 (1946); *Vanderboom* v. *Sexton,* 422 F.2d 1233, 1240 (8th Cir.), *cert. denied,* 400 U.S. 852 (1970).

The burden of proving due diligence lies with the plaintiff who is relying on fraudulent concealment to toll the statute of limitations. *Akron Presform Mold Co.* v. *McNeil Corp.,* 496 F.2d 230 (6th Cir.), *cert. denied,* 419 U.S. 997 (1974). Although the doctrine of fraudulent concealment is the sole basis on which Respondents are rely-

ing to prevent the bar of the statute of limitations, Respondents have submitted no evidence showing that any of them were exercising due diligence.

However, Petitioner has submitted evidence, uncontroverted by Respondents, from which this Court can conclude as a matter of law that Respondents' knowledge and conduct were such that Respondents failed to exercise due diligence in attempting to discover the alleged fraud. Essentially, these are the same facts which cause Respondents to be barred by the doctrine of equitable estoppel. They show, in brief, that Repondents knew, or should have known, that they were dealing with Nay in his individual capacity and not with First Securities. Respondents' purposeful or negligent failure to report this knowledge to any authority requires the finding that Respondents failed as a matter of law to exercise due diligence in attempting to discover the fraud.

ARGUMENT

I. RESPONDENTS MAY NOT PREDICATE THEIR CAUSES OF ACTION AGAINST PETITIONER FOR VIOLATIONS OF SECTION 10(b) AND RULE 10b-5 ON ALLEGATIONS OF NEGLIGENCE IN THE ABSENCE OF ANY ALLEGATION OF DELIBERATE OR INTENTIONAL FRAUD OR RECKLESS OR WILLFUL CONDUCT OR OF KNOWLEDGE OF SUCH FRAUD OR CONDUCT ON THE PART OF PETITIONER.

Respondents' First Amended Complaint alleges that Petitioner negligently failed to exercise proper or appropriate auditing procedures in conducting its audits of First Securities. (A. 13-14). Respondents claim that Petitioner failed to make inquiries which would have led to the discovery that Nay took no regular vacations and that Nay required that all mail addressed to his attention be opened only by him (the "mail rule"). (A. 13-14). According to Respondents, Petitioner should have concluded from this discovery that First Securities' internal accounting control contained a material inadequacy and Petitioner should have reported this inadequacy on the questionnaire Petitioner was required to submit to the Exchange. (A. 15). Respondents also contend that Petitioner's negligence resulted in its erroneously certifying the financial statements of First Securities as presenting fairly the financial condition of First Securities because the statements did not show or contain provision for the "escrow" investments as liabilities of First Securities. (A. 78-81; Respondents' Answers to Petitioner's Interrogatory No. 78). Respondents allege to have relied on Nay's membership in the Exchange and consequently claim

that Petitioner's alleged negligence was the cause of the losses in their "escrow" accounts. (A. 12, 83). Respondents do not accuse Petitioner of deliberate or intentional fraud or reckless or willful conduct or of having any knowledge or awareness of any such fraud or conduct, but only charge Petitioner with committing acts of negligence in its audits of First Securities which Respondents claim "aided and abetted" the fraud committed by Nay. (A. 12-15, 81, 85-86).

The affidavits, interrogatories, depositions and other materials resulting from the extensive discovery procedures undertaken by Respondents and Petitioner, which form the record in this motion for summary judgment, also set forth no evidence that Petitioner had any knowledge or awareness of the alleged fraud committed by Nay.* To the contrary, Respondents' First Amended Complaint and their Answers to Petitioner's Interrogatories Nos. 74-75 and 92 make clear that Respondents are not charging Petitioner with knowledge of any deliberate or intentional fraud or with having any improper motive, but merely with negligence in failing to discover and report certain alleged irregularities in the internal accounting control of First Securities. (A. 12-15, 81-82, 85-86).

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* Respondents were permitted and had full discovery. Petitioner's only objection to a discovery proceeding occurred when, after Respondents' counsel had announced that they had completed discovery and after Petitioner's motion for summary judgment was filed, Respondents sought to take the deposition of all five of Petitioner's affiants, one of whom had already been deposed. (Motion for Protective Order, January 3, 1973). However, the District Court overruled Petitioner's objections and permitted Respondents to proceed with the further discovery they sought. (Decision of McMillen, J., March 19, 1973).

In part II of this brief (pp. 60-78, *infra*), Petitioner will demonstrate that as a matter of law on uncontroverted facts Petitioner committed no acts of negligence in connection with its audits of First Securities, but Petitioner urges here as a threshold issue that such allegations, even if true, cannot and should not support its liability to Respondents in the instant cases.

The statute and rule require, and Petitioner urges this Court to hold, that an essential element that must be proven in all private damage claims under Section 10(b) and Rule 10b-5 is *scienter*, which Petitioner defines as actual knowledge or reckless or willful disregard of fraudulent conduct.* Petitioner does not attempt to define for this Court what "fraudulent conduct" includes nor to argue the role of other elements in Rule 10b-5 actions such as the defendant's duty to the plaintiff or the extent of his participation in the fraudulent conduct. Petitioner seeks only the affirmative holding by this Court that *scienter* is a requisite element of liability that must always be present to support a damage claim under Section 10(b) and Rule 10b-5. On the record in these cases, Petitioner is charged solely with negligence, and it is conceded that it had no knowledge or willful or reckless disregard of Nay's fraudulent conduct. The critical missing element is *scienter*, and the fundamental error of the Court of Appeals was its holding that Petitioner can be liable under Rule 10b-5 for negligence in the absence of *scienter*.

In section **a** hereof (pp. 32-35, *infra*), Petitioner will summarize the Court of Appeals' holding which predicates

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* "*Scienter*" is a term susceptible to varying definitions. *See* 2 Bromberg, *Securities Law: Fraud* §8.4(503). *See also* ALI Fed. Sec. Code §296 AA (Tent. Draft No. 3, 1974).

liability under Section 10(b) and Rule 10b-5 on mere negligence. In sections **b-f** hereof (pp. 36-57, *infra*), Petitioner will demonstrate that the language of Section 10(b) and Rule 10b-5, their legislative and regulator histories, the role Section 10(b) plays in the overall scheme of the securities laws, the majority of the holdings of the Courts of Appeals and strong policy considerations, respectively, all require that the class of defendants who may be found liable under Section 10(b) and Rule 10b-5 be limited to exclude persons who are charged only with negligence and not with deliberate or intentional fraud or reckless or willful conduct or knowledge of such fraud or conduct. Finally, in section **g** hereof (pp. 57-60, *infra*), Petitioner will demonstrate that the negligence standard of the Court of Appeals is particularly inappropriate when the defendant is an aider and abetter and not the primary wrongdoer.

a. The Court Of Appeals Adopted A Negligence Standard In The Instant Cases.

The Court of Appeals noted specifically in its opinion that "[i]n the instant action plaintiffs claim that Ernst & Ernst was *negligent* in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation." (Pet. for Cert. App. A 3a). (Emphasis added). Elsewhere in its opinion, the Court of Appeals stated that "admittedly [Petitioner] had no *knowledge* of Nay's fraudulent escrow scheme." (Pet. for Cert. App. A 4a). (Emphasis added). Nevertheless, relying on its opinion in the companion cases of *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), the Court of Appeals held that a cause of action may be maintained for aiding and abetting a violation of Section 10(b) and Rule 10b-5 if:

> . . . the party charged with aiding and abetting . . . but for a breach of duty of inquiry, should have had knowledge of the fraud, and possessing such knowledge the party failed to act due to . . . breach of a duty of disclosure. (Pet. for Cert. App. A 4a).

Declaring the above-stated formulation "a flexible standard of liability," the Court of Appeals stated that a claim for aiding and abetting through active and inactive facilitation of fraud may be made by demonstrating: (1) that the defendant had a duty of inquiry; (2) that the plaintiff was a beneficiary of that duty; (3) that the defendant breached that duty; (4) that the defendant breached a concomitant duty of disclosure; and (5) that there was a causal connection between the breach of duties of inquiry and disclosure and the facilitation of the underlying fraud. (Pet. for Cert. App. A 4a).

Applying this standard, the Court of Appeals concluded that Respondents had stated a cause of action against Petitioner as the court found: (1) that Petitioner was chargeable with a common law and statutory duty of inquiry; (2) that Respondents were the beneficiaries of the statutory (but not the common law) duty of inquiry;* (3) that whether Petitioner breached its duty

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* Although this issue is not presented to this Court by the Petition for Certiorari, the Court of Appeals erred in holding that Petitioner owed Respondents a statutory duty under Section 17(a) of the 1934 Act, 15 U.S.C. §78q(a) (1970), which provides that broker-dealers must maintain records as required by the SEC. A statutory duty and its inevitable corollary, civil liability, are properly inferred under Section 10(b) and Section 14(a) of the 1934 Act, 15 U.S.C. §78n(a) (1970), as has been recognized by this Court in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971), and *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964).

of inquiry is "to be properly decided by a trial"; (4) that a breach of Petitioner's duty of inquiry requires a corollary finding of a breach of duty of disclosure; and (5) that whether there is any proof of a causal connection between the breach of the duties of inquiry and disclosure and the facilitation of the underlying fraud is an issue properly for trial. (Pet. for Cert. App. A 4a-26a). Accordingly, although it is an undisputed fact that Petitioner committed no act of fraud and had no knowledge or awareness of the fraud allegedly committed by Nay, the Court of Appeals has remanded these cases to the District Court for trial. (Pet. for Cert. App. A 34a).

The Court of Appeals characterized its formulation of liability as an "aiding and abetting" doctrine. Nevertheless, it follows from the opinion of the Court of Appeals that a cause of action may be similarly stated against a principal wrongdoer for negligence in connection with

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* (Continued)

respectively. However, Section 10(b) and Section 14(a) both specify that the conduct defined in the rules and regulations of the SEC thereunder is *unlawful*. In contrast, Section 17(a) does not *prohibit* any conduct but is merely *directive* in nature to broker-dealers (*not* to accountants) and accordingly is not an appropriate provision from which to infer a general duty to the public. A consequence of the Court of Appeals' decision could be that any provision in the securities laws which is directive of conduct gives rise to a general duty for which Rule 10b-5 civil liability is an appropriate remedy. An ill-founded, but logical extension of the Court of Appeals' holding is that accountants could be found liable under Rule 10b-5 for negligently certified financial statements filed under any Section of the 1934 Act which requires the certification of financial statements, *e.g.*, Sections 12, 13, 14 and 15 of the 1934 Act, 15 U.S.C. §§78l, 78m, 78n, 78o (1970).

the purchase or sale of a security. The opinion of the Court of Appeals drew no material distinction between the principal wrongdoer and the aider and abetter in formulating its standard of liability. Moreover, the standard of proof necessary to establish liability for aiding and abetting clearly should not be lower than that needed for the actual violation. If it were otherwise, the law would sanction the anomalous and startling result that a showing of *scienter* would be necessary to render liable a principal in a fraudulent scheme, but that a showing of mere negligence would suffice in the case of an aider and abetter. The self-styled "flexible standard of liability" the Court of Appeals has devised in these cases is, in effect, a rigid formulation which requires a finding of liability in every instance in which a purchaser or seller of a security is injured by an act of negligence committed by another and the requisite duty and causation are present.

In its recent decision in *Blue Chip Stamps* v. *Manor Drug Stores*, ... U.S. ....., 43 U.S.L.W. 4707 (June 9, 1975), this Court limited the class of *plaintiffs* who may maintain a private cause of action for money damages under Section 10(b) and Rule 10b-5 to actual purchasers or sellers of securities. The facts in the instant cases present the complementary question of what limitation should be placed on the class of *defendants* who, as a result of their conduct, may be liable to those plaintiffs. More specifically, the issue before this Court is whether that class of defendants includes persons who are charged only with negligence. Petitioner urges that it should not and does not.

b. The Statutory And Regulatory Language Require Proof of Scienter.

As noted by Mr. Justice Powell in his concurring opinion in *Blue Chip Stamps, supra* at 4717, "[t]he starting point in every case involving construction of a statute is in the language itself." Section 10(b), upon which these actions are based, makes it unlawful for any person to use or employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security in contravention of the rules and regulations promulgated thereunder by the SEC. As Section 10(b) is not self-executing and any liability thereunder is dependent on the rules and regulations of the SEC promulgated in accordance therewith, it is the language of Rule 10b-5 which must be considered at the outset of this discussion.

Rule 10b-5 contains three subsections, each of which declares it unlawful for any person, directly or indirectly, by the use of any means or instrumentality or of the mails or of any facility of any national securities exchange, to engage in the specific conduct or activity set forth in the subsection, in connection with the purchase or sale of any security.

Rule 10b-5(1) prohibits the employment of "any device, scheme, or artifice to *defraud*." (Emphasis added). Rule 10b-5(3) proscribes engaging "in any act, practice or course of business which operates or would operate as a *fraud* or *deceit* upon any person. . . ." (Emphasis added). The clear import of the terms "defraud," "fraud" and "deceit" is that the scope of Rule 10b-5(1) and Rule 10b-5(3) is limited to intentional wrongful conduct or to knowledge of such conduct. *See Trussell* v. *United Under-*

writers, Ltd., 228 F. Supp. 757, 769-770 (D. Colo. 1964); III Loss, *Securities Regulation*, 1441-1442 (2d ed. 1961).

Accordingly, if a cause of action may be properly stated under Rule 10b-5 in the absence of the element of *scienter*, the language on which such cause of action is based must be found in Rule 10b-5(2). Rule 10b-5(2) provides that it is unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . ." Rule 10b-5(2) contains no words such as "defraud," "fraud" and "deceit" which plainly serve to incorporate the element of *scienter* therein. Nevertheless, it is improper to interpret Rule 10b-5(2) as excluding a *scienter* requirement for two reasons:

First, to interpret Rule 10b-5(2) not to include a *scienter* requirement is to render the rule void as being beyond the scope of the authority of the SEC. As stated by this Court in *Dixon* v. *United States*, 381 U.S. 68, 74 (1965):

> The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law . . . but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.

Section 10(b) authorizes the SEC to promulgate rules and regulations to prohibit "any manipulative or deceptive device or contrivance." The Congressional limitation of the rule-making power of the SEC to the proscription of devices and contrivances which are "manipulative and deceptive" implies a requirement that any party found liable under any rule under Section 10(b)

must have either engaged in or known of an act of fraud.* As stated recently by Professor Loss at Loss, *Summary Remarks*, 30 Business Lawyer 163, 165 (1974) (Proceedings ABA National Institute, Responsibilities and Liabilities of Lawyers and Accountants):

> But consider the language of Section 10(b), which so many people overlook. After all, Rule 10b-5 is just a rule, and I take it to be axiomatic that no rule can rise above the Constitution. This statutory phrase is "manipulative or deceptive device or contrivance." Since when is negligent conduct "manipulative or "deceptive"? We are dealing, after all, with the English language. At least, I thought we were.

See also Richland v. *Crandall*, 262 F. Supp. 538, 553 n. 12 (S.D.N.Y. 1967); *Trussell* v. *United Underwriters, Ltd.*, 228 F. Supp. 757, 772 (D. Colo. 1964); III Loss, *Securities Regulation*, 1766 (2d ed. 1961); Note, 82 Harv. L. Rev. 938, 947 (1969).

Second, the better reading of Rule 10b-5 is that Rule 10b-5(1), Rule 10b-5(2) and Rule 10b-5(3) have the same area of operation and were not intended to prohibit three distinct types of conduct. As noted by Chairman Cary of the SEC in *Cady, Roberts & Co.*, 40 SEC 907, 913 (1961): "[t]he three main subdivisions of Section 17 and Rule 10b-5 have been considered to be mutually supporting rather than mutually exclusive." *See also Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951); *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965). Moreover, in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), this Court clearly indicated that Rule 10b-5(2) does not have any unique significance which is not otherwise conveyed by Rule 10b-5(1) and Rule 10b-5(3). In that case this Court, in construing the anti-fraud provision of the Investment Advisors Act of 1940, 15 U.S.C. §80b-6 (1970), which is worded almost identically to Rule 10b-5(1) and 10b-5(3), noted at 375 U.S. 198-199 that the omission of the counterpart to Rule 10b-5(2) had no practical significance except to indicate that Congress considered it to be "surplusage."

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*Websters New Int'l Dictionary (3d ed. 1961) provides the following definitions of the root words manipulate and deceit: Manipulate: "to control, manage, or play upon by artful, unfair, or insidious means esp. to one's own advantage." Deceit: "any trick, collusion, contrivance or underhand practice used to defraud another."

Accordingly, Rule 10b-5(2) cannot be relied on to give Rule 10b-5 an expansive construction. The three clauses of Rule 10b-5 should be read together to import one meaning, which is to proscribe fraudulent conduct, not mere negligence, thereby requiring proof of *scienter*.

c. The Legislative And Regulatory History Require Proof of Scienter.

The Congressional hearings, committee reports and debates which constitute the legislative history of the 1934 Act* provide no affirmative authority for the SEC to expand the scope of the federal securities legislation to include a general prohibition against committing acts of negligence in connection with the purchase or sale of securities. The purpose of Section 10(b) was to give the SEC the power to regulate manipulative practices in order to avoid loopholes in the overall federal securi-

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*For a bibliography of the legislative history of the 1934 Act see Duncan, *Selected Bibliography Including Legislative History of the Securities and Exchange Commission and the Statute It Administers*, 28 Geo. Wash. L. Rev. I, following p. 391 (1959).

ties statutory scheme. S. Rep. No. 792, 73d Cong. 2d Sess. 6 (1934); hearings on H. R. 7852 and H. R. 8720 (Stock Exchange Regulation) before the House Interstate and Foreign Commerce Committee, 73d Cong. 2d Sess. 115 (1934) (testimony of Thomas G. Corcoran, a draftsman of the Act). There is no evidence in the hearings, committee reports or debates that suggests that Congress intended Section 10(b) to impose liability for negligence.

Rule 10b-5 was adopted by the SEC in full accordance with the above-stated Congressional purpose of Section 10(b). Milton Freeman, the draftsman of Rule 10b-5, has stated in Freeman, *Administrative Procedures,* 22 Business Lawyer 891 (1967), that the purpose of the Rule was to extend the provisions of Section 17 of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. §77q (1970) (containing the same general anti-fraud provisions of Rule 10b-5 but pertaining only to sellers or offerers of securities), to purchasers as well. Germane to the issue of whether *scienter* is a requisite element to a private cause of action brought under Rule 10b-5, Mr. Freeman has indicated at 22 Business Lawyer 922 that at the time of adoption of Rule 10b-5, the intention of the SEC was to broaden its authority to combat *fraud*:

> We called the Commission and we got on the calendar. . . . All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against *fraud,* aren't we?" That is how it happened. (Emphasis added).

The SEC release by which Rule 10b-5 was adopted, SEC Securities Exchange Act Release No. 3230 (May 21, 1942), similarly indicates that the purpose of Rule 10b-5 was to broaden the SEC's anti-*fraud* powers:

> The Securities and Exchange Commission today announced the adoption of a rule prohibiting *fraud* by any person in connection with the purchase of securities. The previously existing rules against *fraud* in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against *fraud* administered by the Commission by prohibiting individuals or companies from buying securities if they engage in *fraud* in their purchase. . . . (Emphasis added).

Also, the Annual Report of the Securities Enchange Commission for the year of adoption of Rule 10b-5, 8 SEC Ann. Rep. 10 (1942), uses the word "*fraud*" in connection with its discussion of the rule's adoption.

Accordingly, the import of the relevant statutory and regulatory history is that the SEC enacted Rule 10b-5 with the relatively narrow purpose of proscribing purchasers of securities from committing acts of fraud. There is no evidence that it was the intention of either Congress or the SEC that a rule would issue under Section 10(b) which would render any act of negligence which might happen to occur in connection with the purchase or sale of a security a violation of the federal securities laws, for which civil damages would be an appropriate remedy.

d. The Role Of Section 10(b) In The Overall Regulatory Scheme Of The Securities Laws Requires Proof Of Scienter.

In *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 466 (1969), this Court, in holding that Section 10(b) and Rule 10b-5 applied to misstatements in proxy materials

sent to the shareholders of an insurance company, stated that "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." Accordingly, Section 10(b) should be given an interpretation which tends to make every section of the federal securities laws operative as opposed to one which renders some sections surplusage.

Each of the express non-derivative liability provisions of the 1934 Act contains an explicit state of mind provision as to the defendant which must be found to exist as a precondition to civil liability, and each such provision serves to prohibit the recovery of money damages for mere negligent behavior. Section 9 of the 1934 Act, 15 U.S.C. §78i (1970), prohibits the manipulation of securities registered on a national securities exchange and Section 9(e) thereof specifically authorizes civil liability against any person who "willfully participates" in the conduct proscribed by Section 9(a)-(c). This precludes a plaintiff from bringing an action under Section 9 of the 1934 Act unless conduct more culpable than negligence is alleged.

Section 18 of the 1934 Act, 15 U.S.C. §78r (1970), provides civil liability for misleading statements made in any document filed under the 1934 Act. In defense, the defendant may prove that "he acted in good faith and had no knowledge that such statement was false or misleading."* This defense has been construed liberally in

*It could be argued that it is under Section 18 of the 1934 Act that Respondents should have advanced their claims. However, in order to avoid the *scienter* requirement of Section 18 of the 1934 Act, Respondents elected to sue under Section 10(b) and Rule 10b-5.

favor of the defendant and is tantamount to an actual knowledge requirement. *See* III Loss, *Securities Regulation,* 1752 (2d ed. 1961); Note, 44 Yale L. J. 456, 474 (1935).

Section 20 of the 1934 Act, 15 U.S.C. §78t (1970), imposes liability on controlling persons for violation of any provision of the 1934 Act. The defendant is allowed the defense of proving that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." This "good faith" defense has been interpreted to constitute a *scienter* requirement. *Moerman* v. *Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969).

Accordingly, all the civil liability provisions expressly created by Congress in the 1934 Act require conduct more culpable than negligence in order to give rise to civil damages. Therefore, if Section 10(b) and Rule 10b-5 are held to proscribe negligent as well as fraudulent conduct, plaintiffs will be able to proceed under Section 10(b) and Rule 10b-5 in order to avoid the harsher *scienter* requirements of the express civil liability provisions of the 1934 Act. As stated by this Court in *Blue Chip Stamps, supra* at 4711:

> It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action.

Similarly, it would be anomalous to expand the class of defendants potentially liable under Section 10(b) and Rule 10b-5 beyond the bounds expressly stipulated by Congress in the express liability provisions of the 1934 Act.

In contrast, the express civil liability provisions of the 1933 Act contain less strict *scienter* requirements than the provisions of the 1934 Act. Congress has expressly authorized plaintiffs to proceed against defendants under Sections 11, 12 and 15 of the 1933 Act, 15 U.S.C. §§ 77k, 77l, and 77o (1970), without the obligation of proving *scienter* on the part of defendant; consequently, the construction which the Court of Appeals has placed on Section 10(b) and Rule 10b-5 in these cases results in a *scienter* requirement similar to that explicitly authorized by Congress in the express liability provisions of the 1933 Act. Nonetheless, permitting a suit for negligence under Section 10(b) and Rule 10b-5 frustrates the Congressional purpose with respect to the express liability provisions of the 1933 Act by providing plaintiffs with a means to avoid the specific Congressional provisions as to venue, costs and statutes of limitations applicable to those provisions.

For example, Section 11(e) of the 1933 Act authorizes the court to require a plaintiff bringing suit under either Section 11, Section 12(2) or Section 15 of the 1933 Act to post a bond for costs, including attorney's fees. Section 13 of the 1933 Act provides a one year from violation and three years from offer or sale statute of limitations applicable to Section 11 and Section 12(2) of the 1933 Act. Section 22 of the 1933 Act provides certain venue requirements applicable to a cause of action brought under Section 11, Section 12(2) or Section 15 of the 1933 Act. Accordingly, whenever Congress expressly created under the securities laws a private action as to which negligent conduct would support liability, Congress tempered such cause of action with specific limitations as to costs, venue and time. Permitting Rule 10b-5 actions for negligence without the specific limitations as to cost, venue and time

upsets the balance intentionally provided by Congress and gives claimants a tool which tends to render the express provisions surplusage. The Congressional purpose should be effectuated by holding that a plaintiff may not proceed under Section 10(b) and Rule 10b-5 in the absence of an allegation of something more than negligence on the part of the defendant.

e. The Majority Of The Decisions Of The Courts Of Appeals Requires Proof Of Scienter.

In *Blue Chip Stamps, supra* at 4710, this Court gave substantial consideration to the decisions of the Courts of Appeals which had formulated and consistently applied the principle of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). Similarly, this Court should give weight and consideration to the decisions of the majority of the Courts of Appeals which have held that *scienter* is a requisite element to a private action for damages under Section 10(b) and Rule 10b-5.

In 1951, four years after a civil remedy was first found under Section 10(b) and Rule 10b-5 in *Kardon* v. *National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947), the issue whether proof of fraud or *scienter* is necessary in a private cause of action under Section 10(b) and Rule 10b-5 first surfaced. In *Fischman* v. *Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951), common and preferred shareholders of a corporation sued under Section 10(b) and Rule 10b-5 and Section 11 of the 1933 Act for certain untrue statements and omissions of material fact in a prospectus and registration statement for the sale of preferred stock. The District Court dismissed both counts of the common shareholders' complaint because the common shareholders were not pur-

chasers of the preferred stock which was the subject of the registration statement and because the District Court concluded that it was not a reasonable inference that Congress intended that a suit could be maintained under Section 10(b) and Rule 10b-5 if the same conduct were not actionable under Section 11 of the 1933 Act. The Second Circuit reversed on the basis that Section 10(b) of the 1934 Act and Section 11 of the 1933 Act do not proscribe the same type of conduct. The Court reasoned at 188 F.2d 786-787 that Section 10(b) requires proof of fraud, and that consequently the District Court's logic was defective:

> We think that when, to conduct actionable under §11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under §10(b) of the 1934 Act and the Rule, at the suit of any defrauded person, whether or not he could maintain a suit under §11 of the 1933 Act.

In light of developments in the law since that date, *Fischman* v. *Raytheon* can no longer be read to mean that all the elements of common law fraud must be proved in a private cause of action for damages under Section 10(b) and Rule 10b-5. *See, e.g., Affiliated Ute Citizens* v. *United States.*, 406 U.S. 128 (1972), in which this Court held that under the circumstances of that case the technical common law element of reliance could be proved by inference. Nevertheless, the Second Circuit, clearly and forcefully, has continued to follow the basic teaching of *Fischman* v. *Raytheon* by consistently holding that *scienter* is a requisite element to a private action for damages under Section 10(b) and Rule 10b-5.

The concurring opinion of Judge Friendly in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), best articulates the policy reasons militating against finding liability in a private cause of action for damages when nothing more than negligence is alleged. In that case, Judge Friendly agreed with the majority of the Second Circuit panel that an injunction should properly issue with respect to parties who had committed negligence in the drafting of a press release, but stated specifically that he would refuse to find civil liability under the same circumstances in the absence of *scienter*.* Finding such liability, Judge Friendly stated at 401 F.2d 867, "will lead to large judgments . . . for the benefit of speculators."

Judge Friendly's *dictum* has become law in a series of opinions in the Second Circuit. In *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971), an action against a brokerage firm for losses allegedly arising out of the firm's failure to effect a prompt sell out of the plaintiffs' account, the Second Circuit noted that the plaintiffs' claim was nothing more than a suit for breach of contract, not actionable under Section 10(b) and Rule 10b-5: ". . . in the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme

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*The Second Circuit has held subsequently that proof of *scienter* is not requisite in an SEC suit for an injuction. *See, e.g., SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972); *SEC* v. *Spectrum, Ltd.*, 389 F.2d 535, 542 (2d Cir. 1973). This is fully in accordance with this Court's finding in *SEC* v. *Capital Gains Research Bureau Inc.*, 375 U.S. 180, 193 (1963) that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." *But see SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). Whether *scienter* is requisite to an injunctive action is not, of course, at issue here.

or artifice to defraud. It is insufficient to allege mere negligence. . . ."

Two years later, sitting *en banc* in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), the Second Circuit dismissed a civil action brought under Rule 10b-5 by purchasers of stock against a corporate director for negligent failure to investigate false representations and omissions made by officers and other directors of the corporation. The defendant had neither participated in the negotiations leading to the sale of stock to the plaintiffs nor had he any actual knowledge that false representations and material omissions had been made. Focusing chiefly on the legislative and administrative history of Section 10(b) and Rule 10b-5 and the case law in the Second and other Circuits, the Court of Appeals affirmed the District Court's dismissal of the complaint against the director at 479 F.2d 1302:

> Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants.

The express language of Section 10(b), the Second Circuit continues, "bars adoption of a negligence standard." 479 F.2d at 1305. The minimum standard of culpability required to establish liability under Rule 10b-5 is "willful or reckless disregard for the truth." 479 F.2d at 1306. *See also Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973); *Republic Technology Fund, Inc.* v. *Lionel Corp.*, 483 F.2d 540, 551 (2d Cir. 1973).

The Tenth Circuit, in *Clegg* v. *Conk*, 507 F.2d 1351, 1361-1362 (10th Cir. 1974), *cert. denied*, ... U.S. ....., 43 U.S.L.W. 3659 (June 16, 1975), a case seeking damages under Section 10(b) and Rule 10b-5 and other provisions

of federal and state law allegedly caused by certain untrue material statements and omissions relating to the sale of interests in a car washing business, ruled that the trial court would have erred had it omitted the element of *scienter* from its charge to the jury, stating: ". . . there is required something additional by way of scienter or conscious fault than mere negligence . . . this court has repeatedly declined to extend the acts to cases of simple negligence not involving some fraudulent purpose or species of scienter within their scope and purpose." The Tenth Circuit, at substantial length, explains and distinguishes certain of its earlier decisions, *e.g.*, *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965), which other courts erroneously construed as eliminating any *scienter* requirement.

Similarly, the Fifth Circuit has held in several recent cases that culpability beyond mere negligence is required for liability under Section 10(b) and Rule 10b-5. *See Sargent* v. *Genesco Inc.*, 492 F.2d 750, 761 (5th Cir. 1974); *Smallwood* v. *Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Vohs* v. *Dickson*, 495 F.2d 607 (5th Cir. 1974).

In *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975), an action for an injunction brought by the Securities and Exchange Commission against a corporation and certain of its officers who had allegedly made false statements and omissions of material fact in connection with the sale of certain notes to the State of Ohio, the Sixth Circuit, relying on the Second Circuit's decision in *Lanza* v. *Drexel & Co.*, *supra*, but taking that holding one step further, held that an injunction should not issue in an SEC enforcement action against

the chairman of a corporation as an aider and abetter, since there was no evidence that the chairman had knowledge of the fraud. The Sixth Circuit stated at 493 F.2d 1314:

> Although *Lanza* involved private plaintiffs, and the standards of culpability may be lower in SEC injunctive suits than in private damage actions, SEC v. Capital Gains Bureau, *supra,* the reasoning of the Second Circuit in *Lanza* fully supports our conclusion that the SEC's proof in an injunctive suit must meet the standard of showing "willful or reckless disregard for the truth."

The only holding outside the Seventh Circuit that a private cause of action for damages may be stated without alleging *scienter* is that of the Ninth Circuit in *White* v. *Abrams,* 495 F.2d 724 (9th Cir. 1974). In that case, the trial court had instructed the jury that a defendant could be held liable under Rule 10b-5 if he made a material misrepresentation to the plaintiffs in connection with the sale of security, even if the defendant did not know of the falsity of the misrepresentation. The Ninth Circuit reversed, indicating that this formulation of absolute liability resulted from a misreading by the District Court of the Court of Appeals' opinions in *Ellis* v. *Carter,* 291 F.2d 270 (9th Cir. 1961), and *Royal Air Properties, Inc.* v. *Smith,* 312 F.2d 210 (9th Cir. 1962). On remand, however, the trial court was not instructed to apply a *scienter* test, but a novel "flexible duty standard" which looks to "the extent of the duty that rule 10b-5 imposes on this particular defendant." 495 F.2d at 734-735. The extent of duty will be determined by application of numerous factors, some of which are listed by the court at 495 F.2d 735-736:

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

However, in *Blue Chip Stamps, supra* at 4717, this Court rejected specifically the case-by-case analysis adopted by the Ninth Circuit in modification of the *Birnbaum* rule:

> We do not believe that such a shifting and highly fact-oriented disposition of the issue of who may bring a damage claim for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

The "flexible duty standard" suggested by *White* v. *Abrams* is similarly "a shifting and highly fact-oriented disposition" of the issue who may be liable for damages under Section 10(b). Effectively, this is not a legal standard at all and would make the issue of liability under Section 10(b) and Rule 10b-5 entirely a subjective question to be answered by the jury alone. As stated in Forester, *Rule 10b-5 Violations in the Ninth Circuit: "I Know It When I See It"*, 30 Business Lawyer 773, 780 (1975), a recent commentary on *White* v. *Abrams*:

> Thus each time a jury is given a set of facts, it will determine the law on the basis of those facts, and then apply the law that it has just developed to the facts that it knew in the first place! Surely this is an abrogation of the traditional roles of the court as the interpreter of the laws and the jury as the trier of the facts. It will result in juries *making* laws to fit factual situations, rather than *applying* laws to the facts. The result will be chaotic.

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> as each jury makes up its own laws. Thus the law would be that a person was guilty of a rule 10b-5 violation if he breached his duty, said duty (and law) being subjectively determined by each new jury. The highly technical securities industry cannot live with such a vague, "I know it when I see it," standard in rule 10b-5 actions.

See also the recent comment of Professor Loss with respect to *White* v. *Abrams* in Loss, *Summary Remarks,* 30 Business Lawyer 163, 165 (1974) (Proceedings ABA National Institute, Responsibilities and Liabilities of Lawyers and Accountants): "I must confess that I don't understand how that opinion could possibly work. How is a judge possibly to charge a jury under the sliding scale test?"

In light of the factors discussed heretofore and the the policy considerations, set forth is sections **e-f** hereof (pp. 53-60, *infra*), which militate toward a *scienter* requirement, there is no consideration that should cause this Court to establish a "flexible" standard under which summary judgment cannot be granted even under the most appropriate circumstances.* Accordingly, the case-by-case "flexible duty standard" of *White* v. *Abrams* should be rejected.**

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* As discussed at p. 55, *infra,* of this brief there are strong policy reasons requiring this Court to adopt a *scienter* standard which will permit summary judgment under the appropriate circumstances in causes of action brought under Section 10(b) and Rule 10b-5.

** In *White* v. *Abrams, supra* at 732, the Ninth Circuit stated that in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), the Second Circuit has begun to develop a "duty analysis approach." The Second Circuit in *Chris-Craft* did state at 480 F.2d 363 that "[t]he initial inquiry in each case is what duty of disclosure the law should impose upon the per-

Other than the holdings of the Seventh Circuit and *White* v. *Abrams,* the only support in the Courts of Appeals for a negligence standard for private causes of action for damages under Section 10(b) and Rule 10b-5 is *dicta* in certain decisions of the Eighth Circuit. *See Myzel* v. *Fields,* 386 F.2d 718 (8th Cir.), *cert. denied,* 390 U.S. 951 (1968); *Vanderboom* v. *Sexton,* 422 F.2d 1233 (8th Cir.), *cert. denied,* 400 U.S. 852 (1970); *City National Bank* v. *Vanderboom,* 422 F.2d 221 (8th Cir. 1970). *See also* Bucklo, Scienter *and Rule 10b-5,* 67 Nw. U. L. Rev. 562 (1972).

Accordingly the vast majority of cases decided by the Courts of Appeals have found *scienter* to be a requisite element to a private cause of action brought under Section 10(b) and Rule 10b-5.

f. Strong Policy Considerations Require Proof Of Scienter.

In *Blue Chip Stamps, supra* at 4711, this Court gave weight to "policy considerations . . . to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." Although the statutory and regulatory language and history are sufficient support for

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** (Continued)

son being sued," but nevertheless held "that mere negligent conduct is not sufficient to permit plaintiffs to recover damages in a private action under §17(a) or §10(b)." As held by the Second Circuit in *Chris-Craft,* the extent of the duty between the plaintiff and the defendant may be one factor in determining liability under Section 10(b) and Rule 10b-5; however, for the reasons discussed herein, the Ninth Circuit erred in concluding at 495 F.2d 734 that *scienter* should be rejected as a "necessary and separate element of a 10b-5 action."

this Court to hold that *scienter* is a requisite element to every cause of action brought under Section 10(b) and Rule 10b-5, policy considerations provide a further basis for this conclusion.

This Court recognized in *Blue Chip Stamps, supra* at 4712, "that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." In support thereof this Court cited the concurring opinion of Judge Friendly in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968), that imposing civil liability in undue circumstances "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers. . . ." Although this Court cited this language in support of its holding that the class of plaintiffs with standing to sue under Section 10(b) and Rule 10b-5 is limited to actual purchasers and sellers of securities, the question which Judge Friendly was addressing in *Texas Gulf Sulphur* was whether negligence is conduct sufficiently culpable to find civil liability under the statute and the rule, the precise issue presently before this Court.

In *Blue Chip Stamps,* this Court set forth two separate reasons why the danger of vexatious litigation resulting from a class of plaintiffs consisting of parties other than actual purchasers and sellers of securities is substantial. For the same reasons, the risk of an increase in unjustifiable litigation is probable if this Court elects to expand the class of potential defendants to include parties charged with mere negligence.

First, this Court expressed its concern at 43 U.S.L.W. 4712 that a complaint which may have only a minimal chance of obtaining a judgment at trial nevertheless:

> has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as [the plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.

Moreover, this Court noted at 43 U.S.L.W. 4712-4713 that such frustration and delay are aggravated under Section 10(b) and Rule 10b-5 as there is no applicable provision for attorney's fees and the possibility exists that the liberal discovery provisions of the Federal Rules of Civil Procedure can be used with an *in terrorem* effect of increasing the settlement value of the litigation.

This reasoning is as applicable to the issue presently before this Court as it was to the issue confronted in *Blue Chip Stamps.* Accountants, lawyers and others charged with committing an act of negligence in connection with the purchase or sale of a security may be forced to settle a nuisance suit rather than to undergo a trial which may not only be economically costly but may also tarnish a professional reputation.

Second, unless this Court limits the class of defendants who are potentially liable under Section 10(b) and Rule 10b-5 to those who have knowledge of fraudulent conduct, the defendant's burden of proof, especially in a motion for summary judgment, will be such as to lessen substantially the possibility of summary dismissal of vexatious litigation. A standard which will facilitate defendants to obtain summary judgment and to avoid useless and time consuming trial or forced settlement is a desirable goal in securities litigation, 43 U.S.L.W. at 4713, and this goal would be advanced by adoption of a *scienter* standard.

Finally, the unbridled extension of liability under Section 10(b) and Rule 10b-5 to defendants in general, and in particular to parties such as certified public accounting firms preforming professional services, will result in serious detrimental effects. In noting in *Blue Chip Stamps, supra* at 4717, "that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good," this Court cited a highly relevant observation of Chief Judge Cardozo in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441, 444 (1931), with respect to "a liability in an indeterminate amount for an indeterminate time to an indeterminate class":

> The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of the duty that exposes to these consequences.

The facts which Chief Judge Cardozo was addressing in the *Ultramares* decision were strikingly similar to those presently before this Court: whether a party who made a loan to a corporation had an action for damages against a firm of certified public accountants for misrepresentations in the certification of corporate financial information, which misrepresentations were merely negligent, and not fraudulent, in nature. In holding that the liability of a certified public accountant for an act of negligence does not extend to the investing public generally, Chief Judge Cardozo set forth the following policy reasons:

> Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they

> have overlooked a statute or a decision, to the same extent as if the controversy were one between client and adviser. Title companies insuring titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium. These illustrations may seem to be extreme, but they go little, if any, farther than we are invited to go now. Negligence, moreover, will have one standard when viewed in relation to the employer, and another and at times a stricter standard when viewed in relation to the public. Explanations that might seem plausible, omissions that might be reasonable, if the duty is confined to the employer, conducting a business that presumably at least is not a fraud upon his creditors, might wear another aspect if an independent duty to be suspicious even of one's principal is owing to investors.

g. A Negligence Standard Is Particularly Inappropriate When The Defendant Is Charged Merely With Aiding And Abetting.

The concern which Justice Cardozo expressed in *Ultramares* was well founded. Although the holding of *Ultramares* has retained its vitality with respect to damage claims brought outside Rule 10b-5,* it is Rule 10b-5 claims which have the potential of bringing to pass the undesirable situation which concerned Justice Cardozo. In recent years, Rule 10b-5 suits have commonly come to include as defendants accountants and other persons whose participation in the alleged fraudulent scheme is peripheral or

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* The Court of Appeals in these cases, for example, found on the basis of *Ultramares* that Petitioner owed no common law duty to Respondents. (Pet. for Cert. App. A 10a).

secondary and who are not the primary wrongdoers. *See* Ender, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* in Pari Delicto, *Indemnification, and Contribution,* 120 U. Pa. L. Rev. 597 (1972). Such defendants are likely to lack knowledge of the alleged fraudulent conduct perpetrated by the primary wrongdoer and, by the nature of their lack of participation in the fraud, are less likely to benefit from the fruits of the fraud. Petitioner, for instance, received an annual fee from First Securities of not more than $2,500. (A. 193-194). On the other hand, the damages sought by plaintiffs are frequently enormous. For example, Respondents here claim in excess of $1,000,000. (A. 3; *Martin* 1st Am. Comp. 12). If the Court of Appeals' negligence standard should prevail, the accounting and other professions will be subjected to extremely large claims for damages in situations in which they were merely negligent and had no knowledge or nor participation in any fraud and received no benefit from their relationship with the primary wrongdoer other than a professional fee.

As Ray Garrett, Jr., the present Chairman of the SEC, stated recently in *New Directions in Professional Responsibility,* 29 Business Lawyer 7, 13 (1974) (Special Issue relating to ABA National Institute on Revolution in Securities Regulation held on October 11 to 13, 1973, in Washington, D.C.):

> And I think our law as to civil damages may be anachronistic as applied to affairs of a magnitude so far exceeding the resources of the professional individual or firm.

Mr. Garrett recognizes that accountants, as opposed to actual participants in a securities fraud, are regulated by their own profession and are subject to discipline imposed for violations of ethical standards. Accountants may also be subject to injunctive proceedings by the

SEC under Section 21(e) of the 1934 Act, 15 U.S.C. §78u(e) (1970). Moreover, they are subject to discipline by the SEC in proceedings under Rule 2(e) of the SEC Rules of Practice for failure to meet appropriate professional standards in dealings with the SEC. *See, e.g., Touche Ross & Co.,* SEC Accounting Series Release No. 153 (February 25, 1974) (Touche Ross censured by the SEC, required to adopt certain procedures, and further disciplined in the U.S. Financial matter); *In re Arthur Andersen & Co.,* SEC Accounting Series Release No. 157 (July 8, 1974) (Arthur Andersen censured by the SEC for lack of candor and disclosure in the Whittaker matter); *In re Tubber T. Okuda,* SEC Accounting Series Release No. 170 (January 27, 1975) (Okuda suspended from practice before the SEC for preparing misleading financial statements). Indeed, SEC disciplinary proceedings which result in a suspension of practice before it have a potentially far more serious and substantial financial impact upon accounting firms than would many private damage suits, particularly where the accounting firm is one whose practice includes large, publicly held companies. In light of such serious sanctions, private civil actions for damages based on alleged negligence are not necessary to effect the remedial purpose of the securities laws.

Further, an accountant, under the rules of his profession, can have no financial interest in the company which he is auditing and, accordingly, unless consciously fraudulent, would have no interest in the securities transaction which is the subject of the Rule 10b-5 complaint. *See* CCH AICPA Prof. Stands. ET §52 (1974); SEC Regulation S-X, Rule 2.01, 17 C.F.R. §210.2-01 (1974). Should he commit an act of mere negligence, his potential liability, which can be unlimited under the Seventh Circuit's ruling, will have no proportionate relationship to the fee received

for his services, and the potentially large monetary damages would ultimately require the accounting profession to pass these costs on to the public.

This Court has held that the broad remedial purposes of the securities laws should be furthered by a liberal construction of these laws. *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6 (1971); *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375 (1970). A liberal construction is inarguably necessary with regard to such elements of Rule 10b-5 liability as materiality and reliance where modern-day impersonal securities transactions are such that continuing the classic formulation of fraud liability would result in an impermissible frustration of the purposes of the securities laws. Nor should conduct be restrictively measured against standards of commercial behavior which prevailed generations ago. But no purpose is frustrated nor reasonable investor protection withheld by requiring as an element of Rule 10b-5 liability that the defendant be proven to have acted with knowledge, or willful or reckless disregard, of fraudulent conduct.

II. PETITIONER EXERCISED ALL DUE CARE AND DILIGENCE IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS IN CONDUCTING ITS AUDITS OF FIRST SECURITIES.

Even if a cause of action for damages can be stated under Section 10(b) and Rule 10b-5 if nothing more than negligence is alleged, the undisputed facts in these cases require the conclusion that Petitioner exercised all due care and diligence in auditing First Securities and that the summary judgment granted to Petitioner by the District Court was erroneously reversed by the Court of Appeals.

Respondents have not disputed in the courts below that the standard of care required of Petitioner in auditing First Securities was to conduct its audits in accordance with generally accepted auditing standards prevailing in the auditing profession during the years of its audits. The Court of Appeals, after finding that Respondents could predicate their actions against Petitioner for aiding and abetting Nay's fraud on allegations of negligence, agreed that:

> the fundamental issue in this lawsuit [is]: Whether the uncontroverted evidence reveals that Ernst & Ernst conducted its audits with all due care and in accordance with generally accepted auditing standards. (Pet. for Cert. App. A 13a).

Thus, the only issue presented to this Court is whether Respondents have raised any genuine issue for trial that Petitioner failed to comply with generally accepted auditing standards.

On this issue, the Court of Appeals, ignoring uncontroverted evidence to the contrary, concluded:

> [T]here are genuine issues of material fact to be properly decided by a trial: (1) whether Nay's "mail rule" constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control.* (Pet. for Cert. App. A 18a).

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* The Court of Appeals noted that Respondents' claims against Petitioner require an affirmative finding on *both* these issues. (Pet. for Cert. App. A 18a-19a). As explained in section **c** hereof, however, specific inadequacies in internal accounting control can exist—the proper question is whether the *system* of internal accounting control is adequate. (*See* pp. 73-75, *infra*).

In section **a** hereof (pp. 62-66, *infra*), Petitioner will briefly summarize the generally accepted auditing standards by which Petitioner's conduct should be measured. In sections **b** and **c** (pp. 62-75, *infra*), Petitioner demonstrates that the Court of Appeals has misapprehended and misconstrued the record in these cases by failing to recognize that the affidavits submitted by Petitioner, attesting that Petitioner conducted its audits of First Securities fully in accordance with generally accepted auditing standards and that Nay's alleged "mail rule" was not a material inadequacy in First Securities' internal accounting control, are totally uncontroverted by any evidence submitted by Respondents, and that consequently the District Court properly entered judgment as a matter of law for Petitioner. In section **d** (pp. 75-78, *infra*), Petitioner argues that the Court of Appeals' holding does serious violence to the vitality of the device of summary judgment and that this Court should instruct the Court of Appeals in its proper use.

a. The Generally Accepted Auditing Standards Prevailing At The Time Of Petitioner's Audits Of First Securities Are The Measure Of Its Conduct With Respect To Such Audits.

When accountants undertake to perform any audit, their duty is to meet the standards of care reasonably expected of persons holding themselves out as skilled auditors. Petitioner can find no precedent of this Court or of lower courts holding that an auditor can be held to a standard higher than that of his profession. *See, e.g., Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 703 (S.D.N.Y. 1968) (a federal securities law suit in which the performance of an accounting firm was reviewed in detail).

Auditing standards may be distinguished from accounting principles. The latter define public reporting norms and ultimately seek to arrive at the fair presentment of financial statements to the public. Thus, an accountant may not be able to take full refuge behind generally accepted accounting principles if, in fact, their ultimate effect is to cause financial statements to be unfairly presented. *See United States* v. *Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) (conformity with generally accepted accounting principles no defense to *criminal* prosecution if financial statements do not "fairly present" condition of corporation); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974) (compliance with generally accepted accounting principles will not insulate an accountant from culpability for *fraud*). Auditing standards, on the other hand, are internal professional standards developed and promulgated by the profession to regulate an auditor's conduct in the performance of his audit and are recognized as the proper standard for an auditor's professional conduct. *See* authorities cited at pp. 65-66, *infra*.

Thus, the auditing standards which generally prevailed in the accounting profession during the years of Petitioner's audits of First Securities are the standards by which Petitioner must be measured. This has not been disputed by Respondents, and the Court of Appeals has so held. (Pet. for Cert. App. A 11a).

First Securities' engagement of Petitioner was in response to Section 17(a) of the 1934 Act and SEC Rule 17a-5 thereunder which require every member of a national securities exchange to file with the SEC an annual report of financial condition certified by an independent certified public accountant and meeting the requirements of Form X-17A-5. *See* SEC Rule 17a-5(b)(1), 17 C.F.R. §240.17a-5(b)(1) (1974). The audit require-

ments in Form X-17A-5 at the time of Petitioner's 1967 audit of First Securities were as follows:

> The audit shall be made in *accordance with generally accepted auditing standards* and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date. (Emphasis added).*

The generally accepted auditing standards to which Form X-17A-5 refers are the bundle of accepted practices of auditors expressed or provided for in accounting authorities, now primarily contained and set forth in the pronouncements of the American Institute of Certified Public Accountants (the "AICPA") and its predecessors. *See* the Affidavits of Jerry M. Hooker and John M. Walsh. (A. 104, 150). In particular, the subject of securities broker-dealer audits first received separate treatment by the AICPA in 1956 when its Committee on Auditing Procedures issued an audit guide entitled "Audits of Brokers or Dealers in Securities" (the "1956 Audit Guide").

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* Form X-17A-5 was amended by the SEC in November 1967, effective subsequent to the last audit of First Securities by Petitioner. The form in effect prior to such time thus governed Petitioner's audits of First Securities. *Compare* the 1942 version of the Form *with* the current version. (A. 154-168).

In the 1956 Audit Guide, the AICPA recognized the distinctive nature of the securities business but made clear that the auditor's review of a securities firm is to be made in accordance with generally accepted auditing standards. *See also Wessel* v. *Buhler,* 437 F.2d 279, 283 (9th Cir. 1971); *Caddell* v. *Goodbody & Co.* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶93,938, at 93,740 (N.D. Ala. 1972). The 1956 Audit Guide also stated that the auditor's function is not to discover fraud or irregularities of the firm, as follows at p. 6:

> From the point of view of protection of the proprietors and of the public, emphasis also should continue to be placed upon satisfactory fidelity bonding or other insurance, in addition to adequate internal control, since it must be recognized that *an examination by an independent certified public accountant is not a substitute for these protections and can not be relied upon to disclose defalcations and other similar irregularities,* although their discovery frequently results. (Emphasis added).

This statement was reaffirmed in the AICPA's Statement on Auditing Procedure No. 33 (1963) ("SAP 33"), the official statement of the accounting profession on auditing standards, as follows at p. 11:*

> [T]he ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result . . .

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* More recently, in February 1973, an updated version of the 1956 Audit Guide was published by the Committee on Stockbrokerage Accounting of the AICPA (the "1973 Audit Guide"). The 1973 Audit Guide, although not in effect during Petitioner's audits of First Securities, is consistent with these principles.

> *The responsibility of the independent auditor for failure to detect fraud* (which responsibility differs as to clients and others) *arises only when such failure clearly results from failure to comply with generally accepted auditing standards.* (Emphasis added).

Accordingly, Petitioner's engagement by First Securities to conduct its annual audits was not and cannot be construed to have constituted a guarantee to First Securities, much less to Respondents, to discover fraud or other irregularities in the firm. Petitioner undertook only to audit in accordance with generally accepted auditing standards. Petitioner's acceptance of the engagement did not thereby make it an insurer against losses for fraud—in fact, First Securities, like substantially all broker-dealers, engaged a bonding company to insure against fidelity losses up to $100,000. (Motion to Intervene of Federal Insurance Co., entered April 1, 1975).

Further, assuming that Nay's "mail rule" was a material defect in First Securities' internal accounting control, which, in fact, it was not, Petitioner's liability for failing to discover the "mail rule" arises only if Petitioner failed to comply with generally accepted auditing standards in performing its audits.* In short, it is against the backdrop of its professional duty to audit First Securities in accordance with generally accepted auditing standards that Petitioner's conduct must be measured.

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* Respondents' First Amended Complaint also charges Petitioner with failing to discover that Nay took no regular vacations. (A. 13). However, the uncontroverted evidence of Roy E. Campbell, Assistant Secretary, Secretary, Office Manager and Director of First Securities from 1946 to 1968, was that Nay did in fact take regular vacations. (A. 96). Moreover, Respondents' answers to Petitioner's Interrogatories Nos. 41-43 corroborate Mr. Campbell's evidence. (A. 70-72).

b. Petitioner's Affidavits, Uncontroverted By Any Competent Evidence On The Part Of Respondents, Establish That Petitioner Conducted Its Audits Of First Securities In Accordance With Generally Accepted Auditing Standards.

The Court of Appeals misapprehended Petitioner's and Respondents' affidavits. These affidavits, read properly, demonstrate that Respondents have provided no evidence of negligence on the part of Petitioner and that the Court of Appeals has strained beyond all reasonable bounds to find issues of fact as to Petitioner's exercise of due care in connection with its audits of First Securities.

Petitioner submitted the affidavits of John F. Walsh and Jerry M. Hooker which provide expert opinion that Petitioner's audits were made in accordance with generally accepted auditing standards. (A. 102-135, 148-168).

Mr. Walsh, a certified public accountant and partner with the national accounting firm of Haskins & Sells, has extensive experience in brokerage firm audits. He is primarily engaged in the audits of brokers and dealers in securities and is responsible for the supervision, and is fully familiar with the conduct, of all audits of securities brokers and dealers undertaken by the Chicago office of Haskins & Sells. (A. 148). He is a past Chairman of the Section on Securities Brokers-Dealers of the Specialized Industries Committee of the Illinois Society of Certified Public Accountants and has been a member of the Certified Public Accountants Advisory Committee of the Securities Division of the Office of the Secretary of State of Illinois. (A. 148). As a result of his extensive experience in the auditing of brokers and dealers, he is fully familiar with the rules and authorities applicable thereto. (A. 148-150). Prior to providing his

affidavit, Mr. Walsh reviewed all records and documents relating to Petitioner's 1967 audit of First Securities; all records retained by Petitioner with respect to its audits of First Securities for other years; the audit programs and calendars provided for the audits of First Securities for the years 1960 through 1966; and the affidavits of Jerry M. Hooker, Newell P. Crockett, and LeRoy E. Kist, as well as the affidavit of Roy E. Campbell. (A. 150-151). Such qualifications and knowledge clearly establish Mr. Walsh's independent expert status in matters of broker-dealer audits in general and in the audits of First Securities in particular.

Jerry M. Hooker, a certified public accountant and partner with Petitioner, also specializes in audits of securities broker-dealers and was a member of the Section on Brokers-Dealers of the Specialized Industries Committee of the Illinois Society of Certified Public Accountants. (A. 102-103). Mr. Hooker participated in and had knowledge of the audits of First Securities for the years 1957 to 1967 and is familiar with the accounting methods and procedures and internal accounting control maintained by First Securities. (A. 103). Prior to providing his affidavit, Mr. Hooker reviewed and examined all records of Petitioner with respect to its audits of First Securities, all other relevant records of Petitioner and the affidavit of Roy E. Campbell. (A. 103-105). Mr. Hooker is and was during his participation in the audits of First Securities fully familiar with the rules and authorities applicable to the auditing of securities brokers and dealers. (A. 103-104). While he is not independent, as is Mr. Walsh, Mr. Hooker has full expert qualifications and complete knowledge of the First Securities' audits.

Based on their expertise and in light of their knowledge of Petitioner's audits of First Securities, and specifically assuming the existence of Nay's "mail rule," the respective opinions of Mr. Walsh and Mr. Hooker are that Petitioner's 1967 audit and its 1957 through 1967 audits of First Securities were made in accordance with generally accepted auditing standards and included a review of the accounting system of First Securities, its internal accounting control, and its procedures for safeguarding securities in accordance with generally accepted auditing standards. (A. 103-104, 151-152). Based on the reasonable assumption that Petitioner implemented the audit programs and calendars provided for the years 1960 through 1966, Mr. Walsh's further opinion is that the audits of First Securities for the years 1960 through 1966 complied with generally accepted auditing standards, notwithstanding any lack of inquiry into First Securities' office rules regarding the handling of mail addressed to Nay.* (A. 151-152). The depositions Respondents took of Mr. Hooker and Mr. Walsh after the filing of Petitioner's motion corroborate such opinions. (A. 230-270, 354-392).

Accordingly, Petitioner has supported its motion for summary judgment with evidence in the form of competent expert testimony that it conducted its audits of First Securities, and in particular its review of First Securities' accounting system and internal accounting control and procedures, in accordance with generally accepted auditing standards. Therefore, in order to avoid the entry

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* First Securities maintained procedures concerning the handling of customer mail and the safeguarding of securities. *See* pp. 7-8, *supra,* and Mr. Campbell's affidavit. (A. 97-99).

of summary judgment, Respondents had to meet the burden of setting forth facts by affidavits or otherwise showing a genuine issue for trial.* This they failed to do.

In response to Petitioner's motion for summary judgment, Respondents submitted the affidavits of Michael K. Garst, Gerhard Mayer and Fred J. Duncombe. (A. 168-176).

Mr. Garst is not a certified public accountant but a retired national bank examiner. (A. 168). He reviewed none of Petitioner's workpapers or other documents and had no knowledge concerning the audits of First Securities, and his affidavit evinces no familiarity with generally accepted auditing standards or procedures applicable to the audit of a securities broker-dealer. (A. 168). Mr. Garst does state that if he encountered a case in which a president of a bank had a rule similar to Nay's "mail rule," he would have commented on it in the questionnaire on internal controls to be answered by National Bank Examiners for each bank examined. (A. 168-169). However, Mr. Garst expresses no opinion whether Petitioner's audits failed to meet generally accepted auditing standards and no attempt is made in his affidavit or otherwise to show the relevance of a bank examination by a national bank examiner to the audit of a brokerage firm by an independent accountant. Moreover, Mr. Garst states

* Fed. R. Civ. P. 56(e) provides: "When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him." *See also First National Bank* v. *Cities Service Co.*, 391 U.S. 253, 289-290 (1968).

only that in the circumstances described he would have found a "possible" violation of prescribed national bank procedures. (A. 168).

Gerhard Mayer and Fred J. Duncombe are retired certified public accountants.* (A. 172-174). Mr. Mayer's affidavit states that it is important that an auditor of a securities broker-dealer be satisfied that no single employee or officer have control of an entire transaction and the documentation and records pertaining thereto. (A. 172). He states that it is standard practice for auditors to investigate internal control providing for the segregation of duties and whether duties of persons having control of assets or liabilities or records pertaining to them are rotated periodically. (A. 172-173). Similarly, Mr. Duncombe's affidavit states that it is important that auditors of brokerage firms be assured that no single employee has control of an entire transaction and of the documents and records of the transaction. Accordingly, Mr. Duncombe's affidavit states that auditors should undertake an investigation whether duties and responsibilities are such that no single employee has control of an entire operation and has complete control over both the transactions and the documents with respect to those transactions. (A. 175). Evidently, neither Mr. Mayer nor Mr. Duncombe reviewed the internal control questionnaires in Petitioner's workpapers or Mr. Campbell's affidavit, which establish that Petitioner inquired into and investigated First Securities' system of internal accounting control and that no single First Securities

* As to their qualifications with respect to audits of broker-dealers, Mr. Mayer states none, and Mr. Duncombe states only that he "had several years experience in directing audits of brokerage firms." (A. 172, 173).

employee, especially Nay, had control of an entire operation or complete control over both a transaction and the documents with respect to a transaction.* (A. 96-98, 104-105, 172-176).

The affidavits of Mr. Mayer and Mr. Duncombe express only their personal opinions that an auditor of a broker-dealer firm should investigate the internal control of the firm and should investigate whether there is sufficient duality of control within the firm. (A. 172-176). Both affidavits fail to recognize that Petitioner conducted such investigation in each of its audits. (A. 104-105). Neither of their "opinions" are based on a review of Petitioner's audit documents and workpapers relating to its audits of First Securities; neither reviewed the system of accounting procedures and internal accounting control existing at First Securities nor Mr. Campbell's affidavit regarding the operations at First Securities; and neither "opinion" meets the issue whether Petitioner failed to meet generally accepted auditing standards in conducting its audits. (A. 172-176). On this point, the affidavits of Mr. Walsh and Mr. Hooker stand alone in concluding, on the basis of an actual review of Petitioner's records and papers with

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* First Securities was, in fact, an exemplary brokerage firm in terms of its record keeping and accounting system. *See* the details of this system set forth in Mr. Campbell's affidavit (A. 96-98). Further, First Securities was examined by the NASD, the SEC and the Exchange numerous times over a period of years and was never the subject of any comment that any of its procedures were inadequate. (A. 101). *See* the affidavit and deposition of Mr. John Ahern, Assistant Director of District No. 8 of the NASD (A. 140-147). Also, First Securities was considered to be a model small securities company by the Exchange which, on occasion, would bring employees of newly admitted brokerage firms to the offices of First Securities to view its procedures and systems. (A. 101).

respect to its audits of First Securities and taking into account the totality of the audits, that such audits included an adequate review of First Securities' internal accounting control in accordance with generally accepted auditing standards. (A. 103-105, 150-153). Moreover, the uncontroverted evidence of Mr. Campbell is that sufficient duality of control did in fact exist at First Securities. (A. 96-98). Accordingly, even if Nay's "mail rule" were a material inadequacy in First Securities' internal accounting control (which it was not, as demonstrated *infra*), the uncontroverted evidence in these cases is that Petitioner exercised all due care required of a professional auditor in conducting its audits of First Securities.

c. The Undisputed Facts Demonstrate That Nay's "Mail Rule" Was Not A Material Inadequacy In First Securities' Internal Accounting Control.

The uncontroverted evidence before this Court is that the "mail rule" was *not* a material inadequacy in First Securities' internal accounting control. Therefore, even if Petitioner had discovered Nay's "mail rule" in the course of its audits of First Securities, Petitioner would not have violated generally accepted auditing standards by failing to report it or investigate further.

The nature and function of an auditor's investigation into internal accounting control is not to insure the detection of all irregularities. Its purpose is to determine the extent to which an auditor can rely on the accounting records of the firm to produce a fair reflection of its financial condition and to provide *reasonable* assurance as to the safeguarding of assets against loss from unauthorized use or disposition. The weaker the internal control, the more extensive must be the audit of the books and records of the company if generally accepted

auditing standards are to be met. On the one hand, lack of internal control does not by itself preclude an effective and satisfactory audit. *See generally* AICPA Codification of Auditing Standards and Procedures, pp. 13-35 (1973). On the other hand, adequate internal control does not give any absolute assurance against fraud or the correctness of the financial statements produced. The form of Independent Public Accountant's Supplementary Report on Internal Accounting Control, now provided in the 1973 Audit Guide at pp. 155-56, makes this clear. *See also* SAP 33 at pp. 27-33. However, even this is irrelevant on the instant facts, because Respondents can point to no evidence that there was, in fact, a material inadequacy in First Securities' internal control.

Petitioner's affiant John F. Walsh states that Petitioner's audits of First Securities met generally accepted auditing standards and, specifically assuming the existence of Nay's "mail rule," that the system of internal accounting control was adequate. He further states that in the context of First Securities the existence of Nay's "mail rule" would *in no circumstances* be relevant to or determinative of the existence or lack of internal control. (A. 150-153). Similarly, Petitioner's affiant Jerry M. Hooker states that Petitioner's audits of First Securities were made in accordance with generally accepted auditing standards, that First Securities' accounting system and internal accounting control contained no material inadequacies and that the existence of Nay's "mail rule" did not constitute or result in a lack of internal control at First Securities. (A. 104-106).

In summary, both Mr. Walsh and Mr. Hooker concluded, in light of their review of Petitioner's audit documents, workpapers and other records and, after taking into account the circumstances of First Securities, its accounting system and internal accounting control and in light of generally accepted auditing standards, that the alleged "mail rule" was not a material inadequacy in First Securities' system of internal control. (A. 102-106, 148-153).

Respondents' affiants Gerhard Mayer and Fred J. Duncombe state only that, if, in the course of an audit of a securities brokerage firm, they had discovered a "mail rule" such as Nay's, they would have considered it an irregularity. (A. 173-176). These affidavits set forth nothing more than the personal opinions of Mr. Mayer and Mr. Duncombe concerning what they might have done had they discovered a "mail rule" such as Nay's and cannot be regarded as raising a genuine issue of material fact. Simply put, their opinions are without foundation. Equally important, such affidavits do not measure Petitioner's conduct against generally accepted auditing standards.

Respondents have had every opportunity to provide whatever expert opinion on this issue that they could muster. They chose not to, or more likely could not, provide competent evidence on the critical issue. Consequently, Respondents have failed to refute the testimony of Petitioner's affiants that Nay's "mail rule" was not a material defect in First Securities' internal accounting control and that Petitioner acted in accordance with generally accepted auditing standards.

d. The Court Of Appeals' Failure To Affirm The District Court's Summary Judgment Is Clearly Erroneous, Violates The Standard Of Summary Judgment, And Should Be Corrected By This Court.

A final comment must be made concerning the Court of Appeals' holding on this issue. The court's creating

issues of fact where none truly exist demonstrates the reluctance of that court to utilize the summary judgment device. Respondents' inability to provide competent evidence sufficient to controvert Petitioner's affiants speaks most forcefully to the ripeness of these cases for summary judgment. It is wrong that a federal judge and jury as well as Petitioner should be forced to attend a trial at which Respondents will produce no competent evidence to support their allegations.

As the Seventh Circuit itself has said in *Mintz* v. *Mathers Fund, Inc.*, 463 F.2d 495, 498 (7th Cir. 1972):

> The primary purpose of a motion for summary judgment is to avoid a useless trial, and summary judgment is a procedural device for promptly disposing of actions in which there is no genuine issue of any material fact even though such issue might have been raised by formal pleadings. The very purpose of Rule 56 is to eliminate a trial in such cases where trial is unnecessary and results in delay and expense. Appellate courts should not look the other way to ignore the existence of the genuine issues of material facts, but neither should they strain to find the existence of such genuine issues where none exist.

The Court of Appeals has violated its own mandate, since the evidence in these cases, including the pleadings, the affidavits, the depositions and the answers to interrogatories, makes clear the absence of any genuine issue of material fact concerning the adequacy of Petitioner's audits of First Securities. Petitioner was entitled to a summary judgment as a matter of law on this issue, as the District Court properly found. Petitioner accordingly urges this Court to reaffirm the utility of the summary

judgment device in the Seventh Circuit by instructing the Court of Appeals in its proper use.*

The recent statement of Mr. Justice Rehnquist in *Blue Chip Stamps, supra* at 4713, expressing his concern for the danger of vexatious litigation in Section 10(b) and Rule 10b-5 cases, bears repeating:

> Obviously there is no general legal principle that courts in fashioning substantive law should do so in a manner which makes it easier, rather than more difficult, for a defendant to obtain a summary judgment. But in this type of litigation, where the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proven so before trial, such a factor is not to be totally dismissed.

The present cases provide precisely the situation with which summary judgment was intended to deal. There are no genuine issues of fact and there is only one legal con-

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* Petitioner argued below that no causal connection can be shown as a matter of law between its alleged negligence and Respondents' damages, since, when asked by interrogatory what action the Exchange or other regulatory agency would have taken had Petitioner informed them of the "mail rule," Respondents stated that they were "not able to speculate in this way." (A. 78). The Court of Appeals found it "not . . . entirely outside the realm of reasonableness for the fact finder to infer" that inquiry by Petitioner might have led to the discovery of Nay's fraud. (Pet. for Cert. App. A 25a-26a). Although Petitioner has not presented this issue to this Court, it is an example of the Court of Appeals' searching to find issues of fact in this case and that court's improper disregard of the summary judgment device.

clusion which can be drawn from the facts, which is that Petitioner audited First Securities in accordance with generally accepted auditing standards.

III. RESPONDENTS' KNOWLEDGE AND CONDUCT WERE SUCH TO CAUSE THEIR CLAIMS TO BE BARRED AS A MATTER OF LAW BY THE DOCTRINE OF EQUITABLE ESTOPPEL.

Both the Court of Appeals and the District Court held in these cases, and Respondents never disputed in the courts below, that the doctrine of equitable estoppel may bar a damage action under Section 10(b) and Rule 10b-5. (Pet. for Cert. App. A 31a, App. B 37a). Therefore, the only issue presented to this Court with respect to equitable estoppel is whether under the undisputed facts of these cases Respondents' knowledge and conduct were such that their causes of action are barred as a matter of law. (Pet. for Cert. 20-22).

For purposes of background, Petitioner will present in section **a** (pp. 78-81, *infra*) a short summary of the reasons for the general availability of the doctrine of equitable estoppel in Rule 10b-5 actions. In section **b** hereof (pp. 81-82, *infra*), Petitioner will set forth the elements of the doctrine of equitable estoppel and, in section **c** hereof (pp. 82-90, *infra*), the reasons why Respondents are barred as a matter of law.

a. Equitable Estoppel Is An Available Defense To A Damage Action Under Section 10(b) And Rule 10b-5.

The Courts of Appeals which have addressed this issue have held unanimously that estoppel can apply as a defense to a private damage action brought under the federal securities laws. In *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210, 213-214 (9th Cir. 1962), the Ninth Circuit, in holding that the doctrines of estoppel and

laches could bar a cause of action brought under Section 10(b) of the 1934 Act, stated:

> Since civil liability was judicially implied, the appropriate common law defenses should be applicable. It would be inconsistent to apply these defenses to a remedy specifically provided by Congress and not to a remedy judicially inferred from an act of Congress. Since courts generally interpret statutes in the context of the common law and Congress has not specifically denied the availability of these defenses we see no reason why the ordinary defenses of estoppel and waiver should not be applicable.

See also Dale v. *Rosenfeld*, 229 F.2d 855 (2d Cir. 1956); *Moran* v. *Paine, Webber, Jackson & Curtis*, 279 F.Supp. 573 (W.D. Pa. 1967), *aff'd.*, 389 F.2d 242 (3rd Cir. 1968); *Straley* v. *Universal Uranium and Milling Corp.*, 289 F.2d 370 (9th Cir. 1961); *Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970).

Additionally, in *Holmberg* v. *Armbrecht*, 327 U.S. 392, 395 (1946), a suit to enforce certain liability imposed upon the shareholders of a bank by Section 16 of the Federal Farm Loan Act, 12 U.S.C. §812 (1970), this Court held that when Congress has not clearly set forth the conditions under which a violation of a federal statute will create a private cause of action, the proper inference is that Congress intended the courts to act in accordance with the established doctrines of equity:

> We have the duty of federal courts, sitting as national courts throughout the country, to apply their own principles in enforcing an equitable right created by Congress. When Congress leaves to the federal courts the formulation of remedial details, it can hardly expect them to break with historic principles of equity in the enforcement of federally-created equitable rights.

As stated with respect to Section 10(b) in *Blue Chip Stamps, supra* at 4715, "[w]e are dealing with a private cause of action which has been judicially found to exist and which will to be judicially delimited one way or another. . . ." Accordingly, this Court has already recognized that Section 10(b) is a statute the "remedial details" of which Congress has left to the federal courts for formulation. The "historic principles of equity" should be applicable to any private right of action thereunder.

Numerous decisions of this Court have held that the doctrine of equitable estoppel is one of the "historic principles of equity" which will bar a private cause of action to enforce a right created by federal law. *See, e.g., Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96 (1886); *Dickerson* v. *Colgrove,* 100 U.S. 578 (1880); *Daniels* v. *Tearney,* 102 U.S. 415 (1880); *Drexel* v. *Berney,* 122 U.S. 241 (1887); *Stone* v. *Bank of Commerce,* 174 U.S. 412 (1899); *Arizona* v. *Cooper Queen Consolidated Mining Co.,* 233 U.S. 87 (1914); *Deitrick* v. *Greany,* 309 U.S. 190 (1940).

More recently, in *Glus* v. *Brooklyn Eastern District Terminal,* 359 U.S. 231, 232 (1959), this Court, speaking through Mr. Justice Black, reaffirmed that "the maxim that no man may take advantage of his own wrong" is "[d]eeply rooted in our jurisprudence." Mr. Justice Black, at 359 U.S. 234, cited the following language of this Court in *Union Mutual Life Insurance Co.* v. *Wilkinson,* 80 U.S. (13 Wall.) 222, 233 (1872):

> The principle is that where one party has by his representations or his conduct induced the other party to a transaction to give him an advantage which it would be against equity and good conscience for him to assert, he would not in a court of justice be permitted to avail himself of that advantage.

b. The Elements Of Equitable Estoppel.

It is a general rule of law that where a person has, with knowledge of the facts, acted or conducted himself in a particular manner, he cannot thereafter assume a position inconsistent with such conduct to the prejudice of another who has acted in reliance upon the conduct. *See generally* 31 C.J.S. *Estoppel* §§108-110 and the numerous cases cited therein. The doctrine of estoppel requires consistency of conduct, when inconsistency would accord substantial injury to the other party.

The elements of the doctrine of equitable estoppel are well set forth in *Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96 (1886), in which this Court held that a bank customer was estopped from claiming that a bank was liable to him for paying altered checks drawn on his account since the depositor had not made a timely examination of his check book and pass book which would have caused him to discover and inform the bank of the fraud. Mr. Justice Harlan, summarizing both American and British cases, articulated the doctrine as follows at 117 U.S. 112:

> [W]here a duty is cast upon a person, by the usages of business or otherwise, to disclose the truth (which he has the means, by ordinary diligence, of ascertaining) and he neglects or omits to discharge that duty, whereby another is misled in the very transaction to which the duty relates, he will not be permitted, to the injury of the one misled, to question the construction rationally placed by the latter upon his conduct.

Under this Court's holding, the essential elements of the doctrine of equitable estoppel are: (a) knowledge, actual or constructive, by the party to be estopped of the true facts; (b) the course of conduct by the party to be estopped which amounts to a material failure to disclose or represent such true facts; and (c) justifiable reliance by the party claiming the estoppel upon the conduct of the party to be estopped, resulting in injury, detriment or prejudice to the party claiming the estoppel. *See generally* 31 C.J.S. *Estoppel* §108b.

c. The Doctrine Of Equitable Estoppel Applied To Respondents' Conduct Bars Their Claims As A Matter Of Law.

The gravamen of Respondents' claims is that Petitioner negligently failed to discover Nay's "mail rule" and vacation policy in the course of its audits of First Securities and that, if such discovery had been made and then reported to the Exchange or if such discovery had resulted in the "escrow" investments being carried as liabilities on First Securities' financial statements, Respondents, who claim to have relied on Nay's membership in the Exchange, would not have suffered the damages they now allege.* (A. 10-15, 78-81). Respondents' claims are thus dependent on their contention that the "escrow" investments were investments with First Securities and not with Nay personally and that these investments were or should have been described as liabilities on First Securities' financial statements. This is because Petitioner was

* Petitioner has urged below that the required causal connection between its conduct and Respondents' losses cannot be shown as a matter of law but does not present this issue to the Court. *See* footnote at p. 77, *supra*.

engaged to audit First Securities and not to audit Nay (A. 12, 103, 135, 138) and any duty Petitioner may have owed Respondents must be related to the books and records of First Securities and not to any personal investment with Nay.

The essence of Petitioner's estoppel argument is that Respondents' entire course of dealing with Nay, First Securities and Petitioner demonstrates that Respondents permitted the "escrow" investments to be handled outside the books and records of First Securities as transactions with Nay personally. Accordingly, Respondents are now precluded from contending that such transactions should have been reflected on the books and records of First Securities so that Petitioner can be liable for not discovering and reporting them. The undisputed facts set forth in the record in these cases require the conclusion as a matter of law that Respondents either knew, or should have known, that the "escrow" investments were being made *with Nay personally and not with First Securities.**

Respondents' First Amended Complaint and their answers to Petitioner's Interrogatories Nos. 13 and 15 indicate that the "escrow" investments were not the only

* On the same facts, Petitioner also argued below that it had no duty to Respondents since they permitted their transactions to be handled outside the books and records of First Securities. The Court of Appeals properly held that Petitioner had no common law duty to Respondents, but did find a statutory duty. (Pet. for Cert. App. A 6a-10a). Petitioner has not presented this issue to this Court but does urge that the Court of Appeals was erroneous in such finding of statutory duty on its part. *See* footnote at p. 33-34, *supra*.

investments of Respondents but that all Respondents had regular brokerage accounts with First Securities and regularly purchased and sold securities through such accounts.* (A. 3, 26-61). With respect to such transactions, Petitioner's affiant Roy E. Campbell, who from 1946 until 1968 served in the positions of Cashier, Assistant Secretary, Secretary, Office Manager and Director of First Securities and who was in charge of and was fully familiar with all the books and records of First Securities throughout his period of employment, states that all Respondents received confirmation of purchase or sale forms and regular statements from First Securities. (A. 95-96, 99). Additionally, in connection with the receipt for safekeeping of the securities of a Respondent, the Respondent would sign and return to First Securities a printed safekeeping receipt form. (A. 100). Mr. Campbell's affidavit states that all Respondents who purchased or sold securities by or through First Securities received all or some of these forms in the regular course of their brokerage accounts. (A. 100). Petitioner's affiants Campbell, Hooker, Kist and Crockett state in their respective affidavits that none of Respondents at any time complained to First Securities or to Petitioner concerning their failure to receive First Securities' confirmation of transaction forms, regular statements or other forms with respect to the "escrow" investments. (A. 108-109, 136, 138-139).

Since all Respondents were regular securities customers of First Securities, all Respondents were accustomed

* The Answers of Respondents to Petitioner's Interrogatory No. 15 show that Respondents engaged in hundreds of regular transactions with First Securities. (A. 35-61).

to receiving First Securities' confirmation of transaction forms, regular statements and other forms relating to transactions in their regular brokerage accounts. Accordingly, as Respondents received no such forms with respect to their "escrow" investments and failed to object to not receiving such forms, the conclusion which must be drawn as a matter of law is that Respondents either knew, or should have known, that the "escrow" investments were investments not with First Securities but with Nay in his individual capacity and were outside of the accounting system and books and records of First Securities.

Petitioner's affiant Jerry M. Hooker, a certified public accountant with Petitioner, participated in and had personal knowledge of Petitioner's audits of First Securities for ten years prior to 1967. (A. 103). Petitioner's affiants LeRoy E. Kist and Newell P. Crockett are also certified public accountants with Petitioner and were the supervisors or partners in charge of Petitioner's audits of First Securities from 1946 to 1952 and from 1952 to 1957, respectively. (A. 135, 138). Messrs. Hooker, Crockett and Kist had personal knowledge of all auditing procedures followed by Petitioner in such audits and were fully familiar with the books and records, accounting methods and procedures, and the systems of internal control maintained by First Securities. (A. 103, 135, 138).

Each of Messrs. Hooker, Kist and Crockett states that in connection with all of Petitioner's audits of First Securities during his respective years of supervision all customers of First Securities, including Respondents, whose accounts reflected a securities or cash position or an open contractual commitment on an annual audit date were sent a request by First Securities, mailed by Petitioner, for a

written confirmation of the accuracy of their accounts. (A. 107-108, 136, 138). In each instance where no response was made by the customer within approximately 15 days, a second request was sent by Petitioner. (A. 108). Attached to Mr. Hooker's affidavit are photocopies of the responses of various Respondents to these audit confirmation requests.* (A. 108).

Each of Messrs. Hooker, Kist and Crockett states in his affidavit that none of Respondents ever informed Petitioner that his securities positions, account balances, or statements of open contractual commitments, which never reflected any transactions or positions with respect to the "escrow" investments, were incorrectly reflected on the books and records of First Securities. (A. 109, 136, 138-139).

Accordingly, all Respondents who received audit confirmation requests either knew, or should have known, by examination of such requests, that they did not reflect any transactions or positions with respect to the "escrow" investments. Since no Respondents ever objected to the statements of their accounts as reported on the audit confirmation requests, all Respondents who received audit confirmation requests either knew, or should have known, as a matter of law that the "escrow" investments were investments not with First Securities but with Nay in his individual capacity and would not be reflected on the books and records of First Securities.

Strong policy considerations support the integrity of the audit confirmation requests. Form X-17A-5, promulgated

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* Responses for prior years were destroyed by Petitioner in its ordinary course of business prior to the commencement of Respondents' actions. (A. 108, 136, 138).

by the SEC under Section 17 of the 1934 Act, 15 U.S.C. §78q (1970), and Rule 17a-5 thereunder, 17 C.F.R. §240.-17a-5 (1974), specifically requires that the auditor of a securities broker-dealer obtain such confirmations in the course of his audit. (A. 154-168). Petitioner obtained the Respondents' confirmation responses in full compliance with this requirement of the SEC and accordingly should be able to rely on Respondents' responses. This procedure can only be effective if the auditor is able to rely upon the confirmations of account returned to the auditor by the customers. If, through the fraud of officers or employees of the company, transactions are occurring which do not appear on the books and records of the company, the one certain way by which the auditor can learn of them is from the customer with whom the transactions are conducted. In these cases, those Respondents to whom confirmations of account were sent during the audits of First Securities had a duty to inform Petitioner of their extra-record "escrow" transactions if they now are to claim that Petitioner is liable for them.*

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* The Court of Appeals held with respect to the audit confirmation requests that: "Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be properly decided by the fact finder." (Pet. for Cert. App. A 31a-32a). Not only did the Court of Appeals err in this conclusion by misconstruing the uncontroverted facts in these cases, but the Court of Appeals, by focusing exclusively on the audit confirmation forms in its opinion, erred further in not holding that Respondents' causes of action are barred as a matter of law. It is the totality of Respondents' conduct with respect to Nay and with respect to the "escrow" investments, set forth in detail in the Statement of the Case, *supra,* of which the audit confirmation forms are but one factor, which requires Respondents' causes of action to be barred as a matter of law.

Additional facts which require this Court to conclude that Respondents knew, or should have known, that the "escrow" investments were investments with Nay personally and not with First Securities are set forth in *SEC* v. *First Securities Co.*, 463 F.2d 981, 983-985 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), a successful appeal by Respondents from the disallowance of their claims against First Securities in the equitable receivership proceedings.* Without repeating the facts, Respondents' direct and personal dealings with Nay on a continuous basis make it clear that they knew or should have known (i) that they were dealing with Nay personally and not with First Securities, (ii) that the "escrow" investment were not reflected anywhere in the accounting system of First Securities, and (iii) that neither First Securities nor Petitioner knew of the "escrow" investments.** *See* Statement of the Case at pp. 4-6, *supra*.

* The Court's opinion and the result in the appeal in the receivership proceedings does not conflict with Petitioner's contention that Respondents knew or should have known that their "escrow" investments were not reflected in any way in First Securities' accounting records and that they were dealing with Nay, personally, rather than with First Securities. The theories of liability under which First Securities was held responsible for Nay's actions do not require a finding inconsistent with that now urged. *See also SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), *modifying* 366 F. Supp. 367 (N.D. Ill. 1973), in which Respondents, on principles of equity, were classed as general creditors below regular customers for purposes of the receivership because of the personal nature of their dealings with Nay.

** Were Petitioner charged with fraud in these cases, it might be arguable that Respondents could only be barred by the doctrine of equitable estoppel if Respondents had *actual* knowledge that their dealings were outside of the books and records of First Securities. *Cf. United States*

These facts in support of an estoppel are totally uncontroverted by Respondents. Federal Rule of Civil Procedure 56(e) provides that when a motion for summary judgment is made and supported by affidavits, the adverse party may not rest upon the allegations or denials of his pleading. Respondents have failed to show, by affidavits or otherwise, that there is a genuine issue for trial on any of these estoppel facts. As indicated in *Blue Chip Stamps, supra at* 4713, compelling policy considerations support the granting of summary judgment under the appropriate circumstances in cases brought under Section 10(b) and Rule 10b-5.* The Court should not reject this appropriate opportunity to reaffirm those principles.

The other elements of the doctrine of equitable estoppel are inarguably present as a matter of law in these cases. Respondents failed to disclose to Petitioner, directly or indirectly, the existence or nature of their claimed "escrow" transactions with First Securities. This was clearly a material breach of an obligation required of any reasonable investor to take some appropriate action to correct, rather than confirm, incorrect information about his account which he receives from a brokerage firm

** (Continued)
v. *Georgia-Pacific Co.*, 421 F.2d 92, 97 (9th Cir. 1970), in which the court held that conduct "far short of actual fraud . . . silence, for example . . . if, under the circumstances, [the party] has a duty to speak" is sufficient to raise an estoppel. However, as Petitioner is charged only with negligence in these cases, it would be anomalous to hold that Respondents are not barred by *their* negligence in failing to make proper inquiry with respect to the "escrow" investments.

* *See also* Petitioner's discussion of summary judgment in the Seventh Circuit at pp. 75-78, *supra*.

and its auditors. Respondents action and inaction in this regard go to the heart of their complaint regarding, specifically, the internal accounting control system of First Securities and, generally, Nay's fraud on Respondents by use, in part, of mail to and from First Securities' offices, and the concealment of that fraud from other First Securities' personnel and from Petitioner. They also go to the heart of the auditing process in which direct confirmation statements are given substantial weight and are relied upon as to the general integrity of the client's books and records. The prejudice to Petitioner of such action and inaction by Respondents is substantial and can best be understood by noting that had any one or more Respondents informed Petitioner that certain investments made with First Securities through Nay were not being reflected in information supplied by First Securities, Petitioner would have then been required to conduct an examination and obtain an adequate explanation of the reported discrepancy in First Securities' books and records.*

For these reasons, Respondents are barred as a matter of law from their causes of action by the doctrine of equitable estoppel.

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* Despite the suspicious facts and circumstances of the "escrow," some Respondents may even have had a *bona fide* belief that although the "escrow" investments were investments with Nay and not with First Securities, this practice was not irregular. As discussed at pp. 82-83, *supra*, of this brief, such Respondents are also barred from their causes of action as Petitioner was engaged to audit First Securities and not Nay and cannot be charged with failing to discover fraud outside the scope of its audit of the books and records of First Securities.

IV. RESPONDENTS' CAUSES OF ACTION ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS BECAUSE (i) PETITIONER'S ALLEGED "NEGLIGENT FACILITATION AND IMPLEMENTATION OF FRAUD" CANNOT TOLL THE STATUTE OF LIMITATIONS AND (ii) RESPONDENTS DID NOT AS A MATTER OF LAW EXERCISE THE REQUISITE DUE DILIGENCE IN ATTEMPTING TO DISCOVER THE FRAUD.

The only statute of limitations issue before this Court is whether the limitations period has been tolled by the doctrine of fraudulent concealment. (Pet. for Cert. 16-22). The Petition for Certiorari does not present, nor have Respondents at any time raised, any issue whether their causes of action are controlled by a limitations period other than the three year period of Section 12 of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13 D, found applicable by the District Court and the Court of Appeals. (Pet. for Cert. App. A 32a, App. B 36a).

Although this Court need not consider whether the courts below properly applied the three year limitation of the Illinois Securities Law and when Respondents' causes of action accrued, the brief discussion of these questions in sections **a** and **b** (pp. 92-97, *infra*) supports the correctness of these findings. Sections **c** and **d** (pp. 98-115, *infra.*) demonstrate that the statute of limitations has not been tolled as a matter of law since the undisputed facts in these cases are that Petitioner has done nothing to cause tolling against it while Respondents' action and inaction has rendered the tolling doctrine unavailable to them.

a. The Statute Of Limitations Applicable To Respondents' Causes Of Action Is The Three-Year Limitation Of The Illinois Securities Law.

No provision of the 1934 Act imposes a specific limitation of time on a private action brought to enforce a liability under Section 10(b) and Rule 10b-5. However, in other statutory contexts this Court has sanctioned a principle whereby a limitations period, usually borrowed from state law, is implied when Congress fails to impose an express statute of limitations on a right of action under a statute which it has created. In *UAW* v. *Hoosier Cardinal Corp.*, 383 U.S. 696 (1966), a suit for damages resulting from an alleged violation of a collective bargaining agreement brought against an employer under Section 301 of the Labor Management Relations Act, 29 U.S.C. §185 (1970), this Court, recognizing that Congress had failed to legislate a specific limitations period applicable to the cause of action, held that the proper limitations period was to be determined, as a matter of federal law, by reference to the appropriate state statute of limitations. Citing a long succession of its own decisions and the decisions of other federal courts, this Court noted with approval at 383 U.S. 704 that:

> [S]tate statutes have repeatedly supplied the periods of limitations for federal causes of action when federal legislation has been silent on the question.

In holding that the limitations period applicable to the plaintiffs' cause of action should be determined by reference to state law, this Court rejected at 383 U.S. 702-703 the defendant's contention that the Court should formulate a uniform statute of limitations:

> Lack of uniformity in this area is therefore unlikely to frustrate in any important way the achievement

> of any significant goal of labor policy. . . . [T]here is no justification for the drastic sort of judicial legislation that is urged upon us.

See also Rawlings v. *Ray*, 312 U.S. 96 (1941); *Cope* v. *Anderson*, 331 U.S. 461 (1947); *Johnson* v. *Railway Express Agency, Inc.*, ... U.S. ....., 43 U.S.L.W. 4623 (May 19, 1975).

Similarly, lack of uniformity with respect to the statute of limitations applicable to causes of action brought under Section 10(b) and Rule 10b-5 frustrates in no significant way the policies advanced by the federal securities laws. To the contrary, an inference may be drawn that Congress did not intend to impose a single statute of limitations on actions brought under Section 10(b) and Rule 10b-5. When Congress believed a certain provision in the securities laws merited a uniform statute of limitations, Congress specifically imposed a limitations period.* Moreover, Congress has twice amended limitations periods in the securities laws.** This concern with limitations periods applicable to the securities laws is evidence that if Congress desired to impose a uniform

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* *See* Section 13 of the 1933 Act, 15 U.S.C. §77m (1970); Section 9(e), Section 16(b), Section 18(c) and Section 29(b) of the 1934 Act, 15 U.S.C. §§78i(e), 78p(b), 78r(c), 78cc(b) (1970).

** The 1933 Act originally stipulated a limitations period of two years from discovery for all actions brought thereunder with a ten year overall limitation applicable to all actions except those brought under Section 12(2). 48 Stat. 84 (1933). The present one year from discovery and three years from offer or sale limitation of Section 13 results from a 1934 amendment. 48 Stat. 908 (1934). The one year from discovery and three years from violation limitation of Section 29(b) of the 1934 Act was added by a 1938 amendment. 52 Stat. 1076 (1938).

statute of limitations to causes of action brought under Section 10(b) and Rule 10b-5, it would have affirmatively done so by amendment to the 1934 Act after it became evident that the courts had implied a private cause of action under Section 10(b) and Rule 10b-5. Similarly, in *UAW* v. *Hoosier Cardinal Corp., supra* at 703, this Court concluded that the silence of Congress with respect to the limitations period applicable to suits brought under Section 301 of the Labor Management Relations Act, in light of the extensive attention Congress devoted to other limitations problems under that statute, gave rise to the inference that Congress expected the courts to devise a limitations period by the traditional practice of reference to state law.

Additionally, the Courts of Appeals which have addressed this issue have been unanimous in holding that the statute of limitations applicable to a private cause of action brought under Section 10(b) and Rule 10b-5 is determined by reference to appropriate state law. *See, e.g., Janigan* v. *Taylor*, 344 F.2d 781, 783 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Sargent* v. *Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir. 1974); *Charney* v. *Thomas*, 372 F.2d 97, 99 (6th Cir. 1967); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 125 (7th Cir. 1972); *Myzel* v. *Fields*, 386 F.2d 718, 742 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912, 914 (9th Cir. 1971); *deHaas* v. *Empire Petroleum Co.*, 435 F.2d 1223, 1225 (10th Cir. 1970).

Therefore, as Illinois is the forum state of this litigation, the appropriate Illinois statute of limitations controls the Respondents' causes of action. As suggested by this Court in *UAW* v. *Hoosier Cardinal Corp., supra* at 706, which Illinois statute of limitations is applicable to

these actions is a question of "characterization." Selecting the appropriate statute of limitations depends on which statute "best effectuates" the federal policy at issue. *Charney* v. *Thomas*, 372 F.2d 97, 100 (6th Cir. 1967); *Vanderboom* v. *Sexton*, 422 F.2d 1233, 1237 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970).

The Seventh Circuit in *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), properly characterized a private cause of action brought under Section 10(b) and Rule 10b-5 as bearing the closest resemblance to Section 12 of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.12 (1973). Therefore, the Court of Appeals concluded that the three year limitation of Section 13 D of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13 D (1973), was applicable. The Seventh Circuit observed at 455 F.2d 126-127 that the Illinois Securities Law "has a similar purpose" to the federal securities laws, that the three year limitation period is "closer to the express limitations periods in the various sections of the federal act," and that selection of the limitation of the Illinois Securities Law tends "more toward an orderly development of law, than reaching into a different Illinois Act" and "better effectuates the federal policy expressed in 10b-5."

b. Respondents' Causes Of Action Accrued More Than Three Years Before They Filed Their Original Complaints And Are Therefore Barred By The Applicable Statute Of Limitations Unless The Statute Has Been Tolled By The Federal Doctrine Of Fraudulent Concealment.

The District Court held that all Respondents are barred by the applicable three year statute of limitations. (Pet. for Cert. App. B 36a). The Court of Appeals reversed the

District Court only because it found that Respondents raised an issue for trial that they might avail themselves of the equitable tolling doctrine. (Pet. for Cert. App. A 32a-34a). Respondents have not raised at any time any other grounds which might prevent the bar of the statute of limitations. Their sole reliance is on the federal doctrine of fraudulent concealment. Therefore, the only question properly before this Court regarding the statute of limitations is whether Respondents may rely on that doctrine. The questions when Respondents' causes of action accrued and whether the limitations period has expired in the absence of the availability of the federal tolling doctrine, although discussed briefly hereafter, need not be considered by this Court.

Respondents' respective causes of action accrued when Petitioner performed that annual audit of First Securities which allegedly failed to result in the discovery that an "escrow" investment of a Respondent was spurious and remitted its report thereon to the Midwest Stock Exchange, as this is the only "act" of Petitioner which Respondents claim caused them injury. (A. 12-15). Petitioner also understands that *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 401 U.S. 321 (1971), may require that a cause of action accrued to Respondents each time Respondents were allegedly injured by an "act" of Petitioner (*i.e.*, an annual audit of First Securities conducted by Petitioner which failed to result in the discovery of the alleged fraud). However, the uncontroverted evidence before this Court is that the *last* act of Petitioner which could have caused *any* alleged injury to *any* Respondent occurred in December 1967 when Petitioner issued its report with respect to the last audit

of First Securities which Petitioner conducted as of October 31, 1967.* (A. 103).

Respondents filed their initial complaints against Petitioner on February 19, 1971 and May 18, 1971. (A. 1). By these dates, more than three years had elapsed from the last possible date any of Respondents' causes of action may have accrued, for no cause of action accrued after 1967. Therefore, Respondents are barred from their causes of action by the applicable three year statute of limitations unless the statute of limitations was tolled from the dates the causes of action accrued until some date after February 19, 1968 and May 18, 1968, three years prior to the respective dates on which Respondents filed their initial complaints herein.

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* December 1967 is the *last* possible date that the cause of action of any Respondent could have arisen. The answers of Respondents to Petitioner's Interrogatory No. 35 indicate, however, that the last "escrow" investment of many of the Respondents was made in years prior to the 1967 audit year. *E.g.*, the last "escrow" investment of Respondent Agnes Smith was made in 1953, of Respondent Helen Feldkamp in 1957 and of Respondent L. Stanbridge Martin in 1965. Moreover, the answers of all Respondents to Petitioner's Interrogatory No. 40 is that Nay converted the "escrow" investments to his own use *immediately upon receipt*. Accordingly, it may be argued that the last "act of Petitioner causing any individual Respondent's injury was Petitioner's audit in the year of such Respondent's last "escrow" investment and that such Respondent's cause of action, barring application of the doctrine of fraudulent concealment, accrued on the date of Petitioner's audit report in the year of such Respondent's last "escrow" investment.

c. Respondents May Not Rely On Petitioner's Alleged "Negligent Facilitation And Implementation" Of Fraud To Toll The Applicable Statute Of Limitations.

Respondents have taken the position below, and the Court of Appeals has held, that Respondents are not barred as a matter of law by the statute of limitations. Respondents have argued, and the Court of Appeals has agreed, that the federal fraudulent concealment doctrine may be available to Respondents and that therefore the statute of limitations may have been tolled. (Pet. for Cert. App. A 34a).

Petitioner does not dispute the existence of the federal doctrine of fraudulent concealment, adopted by this Court in *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342 (1875), nor that *Holmberg* v. *Armbrecht,* 327 U.S. 392 (1946), requires that this doctrine control the issue whether a state statute of limitations applicable to a federal cause of action is tolled by fraudulent concealment.* However, it is an uncontroverted fact in these cases that Petitioner is

* In *Johnson* v. *Railway Express Agency, Inc.,* ..... U.S. ....., 43 U.S.L.W. 4623 (May 19, 1975), this Court held that it is primarily a question of state law whether the state statute of limitations applicable to a cause of action under 42 U.S.C. §1981 (1970) is tolled by the timely filing of an employment discrimination charge based on the same facts with the Equal Employment Opportunity Commission pursuant to Section 706 of Title VII of the Civil Rights Act of 1964, 42 U.S.C. §2000e-5 (1970). That case does not concern the well-established federal doctrine of fraudulent concealment and the majority opinion does not overrule or even discuss *Holmberg* v. *Armbrecht.* Consequently, whether a state statute of limitations applicable to a federal cause of action is tolled by fraudulent concealment remains a question of application of the *federal* fraudulent concealment doctrine.

charged only with negligence and not with committing, or having knowledge or awareness of, acts of fraud, nor with fraudulent concealment or other reckless or willful conduct. (A. 12-15, 81, 85-86). Petitioner is not alleged to have taken any steps to conceal anything it or Nay did and indeed the record is clear that the only affirmative action taken by Petitioner was to audit First Securities and report on its financial statements. (A. 12-15, 103, 135, 138). As a result, the conclusion of the Court of Appeals that the doctrine of fraudulent concealment may be available to Respondents was erroneous.

The Court of Appeals circumvented Petitioner's total and conceded lack of active involvement in any fraudulent activity by holding that Petitioner's "negligent facilitation and implementation of Nay's fraud" can serve to toll the statute. (Pet. for Cert. App. A 34a). This conclusion, and the similar conclusion of the Court of Appeals in the companion cases of *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), are contrary to the holdings of this Court, are unique to the federal jurisprudence, and are patently incompatible with the public policy underlying statutes of limitations, the doctrine of fraudulent concealment and Section 10(b) and Rule 10b-5.

As *Holmberg* v. *Armbrecht,* 327 U.S. 392, 397 (1946), holds that the application of the judicially created doctrine of fraudulent concealment to the state statute of limitations relevant to a federal right is a federal question, the holdings of this Court are the authoritative guide to proper application of the doctrine.

In *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342, 349 (1875), the initial case in which this Court adopted the doctrine of fraudulent concealment, this Court held that the de-

fendants, who had fraudulently conspired with a bankrupt to convey the bankrupt's property to them, could not rely on the statute of limitations to bar an action brought by the assignee of the bankrupt to set aside the conveyances, as the fraudulent concealment of the defendants had tolled the statute. The opinion of this Court at 88 U.S. (21 Wall.) 349 articulated the policy supporting the doctrine of fraudulent concealment with clear intent to limit its application to instances where *the party who sought to raise the bar of the statute of limitations* concealed or committed fraud:

> To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time *as the party committing the fraud could plead the Statute of Limitations* to protect it, is to make the law which was designed to prevent fraud, the means by which it is made successful and secure. (Emphasis added).

In *American Pipe and Construction Co.* v. *Utah*, 414 U.S. 538, 553 (1974), a case decided by this Court during its term immediately preceding the filing of this brief, this Court held that in the context of the facts presented, the commencement of an original class action for civil damages under the antitrust laws tolls the running of the statute of limitations for all purported members of the class who make timely motions to intervene In its general discussion of the power of the federal courts to toll statutes of limitations, this Court noted at 414 U.S. 559 that inducement and fraudulent concealment are well-established bases for the tolling of statutes of limitations, but specifically limited their availability to instances where the *defendant* has committed the act of inducement or fraudulent concealment relied upon to toll the statute:

> [I]n cases where the plaintiff has refrained from commencing suit during the period of limitation because of inducement by the defendant, Glus v. Brooklyn Eastern Terminal, 359 U.S. 231, 3 L.Ed. 2d 770, 79 S.Ct. 760, or because of fraudulent concealment, Holmberg v. Armbrecht, 327 U.S. 392, 90 L.Ed. 743, 66 S.Ct. 582, 162 ALR 718, this Court has not hesitated to find the statutory period tolled or suspended *by the conduct of the Defendant.* (Emphasis added).

On numerous additional occasions this Court has upheld the application of the doctrine of fraudulent concealment under appropriate circumstances, but in no instance has it so held when neither the defendant in the case at bar nor the defendant's privy committed, or had knowledge of, an act of fraud or fraudulent concealment. *See, e.g., United States* v. *Diamond Coal & Coke Co.*, 255 U.S. 323 (1921) (defendant charged with conspiracy to deprive the United States of patents to certain land); *Holmberg* v. *Armbrecht*, 327 U.S. 392 (1945) (defendants charged with the active fraudulent concealment of their ownership of bank shares in order to avoid liabilities imposed on them by law to the bank's creditors).

Additionally, the decisions of the Court of Appeals in the instant cases and in the companion cases of *Hochfelder* v. *Midwest Stock Exchange, supra,* are without support in any decision of the lower federal courts. To the contrary, two Courts of Appeals have held that the doctrine of fraudulent concealment may not toll a statute of limitations if the defendant who is relying on the bar of the statute of limitations has committed no act of fraud or fraudulent concealment.

In *Cato* v. *Southern Atlantic & Gulf Coast District of International Longshoremen's Association*, 364 F. Supp. 489 (S.D. Tex.) *aff'd sub nom. Cato* v. *International*

Longshoreman's Association, 485 F.2d 583 (5th Cir. 1973), an action was brought by certain union members against their district union and their employer. The plaintiffs alleged that the defendant-employers had terminated their employment without the notice and opportunity to bargain required by the Railway Labor Act, 45 U.S.C. §161 *et seq.* (1970). The District Court held that the plaintiff's action against the defendant-employers was barred by the applicable statute of limitations and rejected the plaintiffs' argument that the statute was tolled by certain misrepresentations made by the defendant-union representatives who led the plaintiffs to believe that they were parties to another action which would have provided the plaintiffs with the relief they were presently seeking. No allegation was made that the defendant-employers had themselves made any fraudulent misrepresentations. The District Court held at 364 F. Supp. 493:

> Generally the acts of third parties in concealing a cause of action will not prevent the running of the limitations period as to the real defendant. The action by union officials can preserve plaintiffs' claim against the defendant district union, but it cannot save their claim against these defendants.

The Fifth Circuit, affirming *per curiam,* specifically noted at 485 F.2d 583 its agreement with the District Court that the plaintiffs' claim under the Railway Labor Act "is barred by the statute of limitations." *Accord, Powell* v. *Radkins,* 506 F.2d 763 (5th Cir. 1975).

Similarly, in *Bryan* v. *United States,* 99 F.2d 549, 552 (10th Cir. 1938), *cert. denied,* 305 U.S. 661 (1939), the plaintiffs asserted that the statute of limitations otherwise barring their action to recover overpayment of income taxes had been tolled by the fraudulent concealment

of agents of the United States that income tax returns filed and payments of income tax made were incorrect and excessive. The Tenth Circuit, at 99 F.2d 552, specifically rejected the plaintiffs' contention that a statute of limitations may be tolled by fraudulent concealment committed by a non-party to the litigation:

> The United States is not liable for unauthorized wrongs inflicted by its officers or agents on its citizens, although occurring while engaged in the discharge of official duties. Schillinger v. United States, 155 U.S. 163, 167, 15 S.Ct. 85, 39 L.Ed. 108. *The fraudulent concealment must have been that of the party sought to be charged,* and a fraudulent concealment by one who stands in the relation of agent to another will not bind the principal, unless the latter induced or had knowledge thereof. (Emphasis added).

Moreover, the federal decisions holding the doctrine of fraudulent concealment applicable under given circumstances are replete with *dicta* indicating that the doctrine is properly invoked only because the *defendant* committed the act of fraud or fraudulent concealment. *See, e.g., Detroit* v. *Grinnell Corp.,* 495 F.2d 448, 460 (2d Cir. 1974); *Public Service Co.* v. *General Electric Co.,* 315 F.2d 306, 310 (10th Cir. 1963).

Accordingly, in each instance in which this Court or a lower federal court has held that the federal doctrine of fraudulent concealment has tolled a statute of limitations, the defendant in the lawsuit who was relying on the bar of the statute of limitations committed or had knowledge of an act of fraud or of fraudulent concealment. These cases are fundamentally distinguishable from the cases at bar in which Petitioner is charged only with negligence in its audits of First Securities and not with commission or knowledge or awareness of any fraud, cover-up or conceal-

ment or any other reckless or willful conduct. (A. 12-15, 81, 85-86).

Furthermore, the policies underlying the statute of limitations, the doctrine of fraudulent concealment and Section 10(b) and Rule 10b-5 are best advanced if the doctrine of fraudulent concealment applies only where the defendant actively participated in, or had knowledge of, or at least had some awareness of an act of fraud or of fraudulent concealment.

As stated in *Burnett* v. *New York Cent. R.R.*, 380 U.S. 424, 428 (1965), in which this Court held that the statute of limitations applicable to a suit commenced in a federal court to enforce a liability under the Federal Employers' Liability Act, 45 U.S.C. §161 *et seq.* (1970), was tolled by a prior suit brought in a state court to enforce the same liability:

> The basic question to be answered in determining whether, under a given set of facts, a statute of limitations is to be tolled, is one "of legislative intent whether the right shall be enforceable . . . after the prescribed time." Midstate Horticultural Co. v. Pennsylvania R. Co., 320 U.S. 356, 360, 88 L.ed. 96, 101, 64 S.Ct. 128. . . . [T]he basic inquiry is whether congressional purpose is effectuated by tolling the statute of limitation in given circumstances.
>
> In order to determine congressional intent, we must examine the purposes and policies underlying the limitation provision, the Act itself, and the remedial scheme developed for the enforcement of the rights given by the Act.

Consequently, whether the statute of limitations should be tolled by Petitioner's alleged "negligent facilitation and implementation" of Nay's fraud is properly to be answered by an examination of the purposes and policies underlying the statute of limitations, including the doctrine of fraudulent concealment implicit therein, and Section 10(b) and Rule 10b-5.

In *Burnett* v. *New York Central R.R., supra* at 428, this Court further stated that the purpose of statutes of limitations is to advance the compelling policy of protecting defendants and the courts from stale claims by requiring plaintiffs to give defendants notice of their claims within the period specified by the statute:

> Statutes of limitations are primarily designed to assure fairness to defendants. Such statutes "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them." Order of Railroad Telegraphers v. Railway Express Agency, Inc., 321 U.S. 342, 348-349, 88 L.ed. 788, 792, 64 S.Ct. 582. Moreover, the courts ought to be relieved of the burden of trying stale claims when a plaintiff has slept on his rights.

The grafting of the doctrine of fraudulent concealment onto the statute of limitations may be justified by two possible rationales. The first is that an innocent plaintiff should not be deprived of his cause of action by a statute of limitations if such cause of action has been unwittingly concealed from him by fraud committed by another party. The second is that the purpose of the doctrine of fraudulent concealment is to prevent fraud by prohibiting persons who have committed, or who have knowledge of, an

act of fraud or fraudulent concealment from relying on a statute of limitations.

Petitioner submits that the primary policy advanced by the doctrine of fraudulent concealment cannot be the protection of the innocent plaintiff, as it is well established that the compelling policy of the statute of limitations in protecting defendants and courts from stale claims outweighs the consideration of an innocent plaintiff not otherwise being able to advance his claim. The mere fact that a person entitled to an action is ignorant of his right to sue or of the facts out of which his right arises does not of itself prevent the running of a statute of limitations. *See, e.g.*, 51 Am. Jur. 2d *Estoppel* §146; *Moviecolor Ltd.* v. *Eastman Kodak Co.*, 288 F.2d 80, 87 (2d Cir. 1961); *Riley* v. *United States*, 212 F.2d 692, 695 (4th Cir. 1954); *United States* v. *One 1961 Red Chevrolet Impala Sedan*, 457 F.2d 1353, 1358 (5th Cir. 1972); *Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230, 234 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974).

Consequently, the primary purpose of the doctrine of fraudulent concealment cannot be to protect "innocent" plaintiffs, as Respondents purport to be, from deprivation of their causes of action, but rather *to discourage parties from committing acts of fraud or fraudulent concealment.** This conclusion is not only dictated by the foregoing analysis, but is also required by the policy expressed by the language of this Court in the seminal case of *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 349 (1875):

> To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time as the party committing the fraud could plead

* On the undisputed facts, Respondents are far from innocent as demonstrated in section **d**, pp. 109-115, *infra*, hereof.

> the Statute of Limitations to protect it, *is to make the law which was designed to prevent fraud the means by which it is made successful and secure.* (Emphasis added).

The prevention of fraud, being the primary purpose of the doctrine of fraudulent concealment, is achieved only by depriving those parties who have committed or have knowledge of an act of fraud or of fraudulent concealment from relying on a statute of limitations. Therefore, as Petitioner is not charged with committing or having any knowledge of an act of fraud or of fraudulent concealment, the policy underlying the doctrine of fraudulent concealment is not advanced by holding that the applicable statute of limitations can be tolled by the acts of fraud or fraudulent concealment committed by Nay.

Furthermore, even if the primary purpose underlying the doctrine of fraudulent concealment is to protect "innocent" plaintiffs and the policy of protecting defendants which underlies the statute of limitations is to be ignored, denying the availability of the doctrine against an allegedly negligent *aider and abetter* as Respondent is alleged to have been (A. 12-15) will not thwart the doctrine's purpose by barring an innocent plaintiff from asserting his rights, for such plaintiff would not be barred from his cause of action against the person who was *primarily responsible* for the wrong. In fact, Respondents in these cases are not barred from their causes of action and, indeed, have already successfully asserted their claims against First Securities. *See SEC* v. *First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973).

In addition, limiting the application of the doctrine of fraudulent concealment to instances where the defendant has engaged in an act of fraud or of fraudulent conceal-

ment is entirely consistent with Congressional intent and the purpose and policy of Section 10(b) and Rule 10b-5.

Congress and the SEC intended Section 10(b) and Rule 10b-5 to be *fraud* provisions. *See* pp. 36-45 of this brief, *supra*. It is entirely consistent with this intention to require fraud or knowledge of fraud to toll the statute of limitations applicable to a cause of action under the statute and the rule. In light of the silence of Congress with respect to the statute of limitations applicable to actions brought under Section 10(b) and Rule 10b-5, the most reasonable inference is that by implicitly authorizing the courts to formulate an applicable statute, Congress intended that the basic protection of the doctrine of the statute of limitations, being the protection of defendants and the courts from stale claims, be available and that actual fraudulent concealment be required to toll the statute.

Finally, public policy requires reversal of the Court of Appeals' holding that negligent facilitation of another's continuing fraud is sufficient to toll *any* running of the applicable statute of limitations against an allegedly negligent party. Such holding has drastic implications for professionals such as accountants and is an unwarranted extension of the limits of aiding and abetting liability under Rule 10b-5. The Court of Appeals has effectively held that a statute of limitations will never run with respect to a professional's negligence where, by happenstance, a potential plaintiff is injured by another's continuing fraud and, by further happenstance, that fraud involves a security. This demonstrates an intolerable disregard of the strong reasons underlying statutes of limitations—that claims become stale, witnesses' memories lapse, documents are discarded, and prejudice to defendants consequently results. This is especially true in the present case where Nay's fraud began long before Petitioner's last audit of First Securities and where certain Respondents are seeking recovery from Petitioner for investments made as early as 1942. (A. 103, 135, 138; Answer of Respondent Zerah H. Drake to Petitioner's Interrogatory No. 35). Moreover, Petitioner's record retention policy has caused it to discard audit confirmation requests and most other audit documents compiled prior to 1961 which would undoubtedly have yielded additional relevant evidence concerning Respondents' knowledge and conduct. (A. 108, 136, 138). Simply put, the policies underlying statutes of limitations must be recognized by this Court and accorded their proper weight; negligence does not warrant open-ended liability without limitation and should not support a tolling of the statute.

d. Respondents' Causes Of Action Are Barred By The Applicable Statute Of Limitations Because Respondents As A Matter Of Law Failed To Exercise Due Diligence In Attempting To Discover Nay's Fraud And Therefore Cannot Rely On The Doctrine Of Fraudulent Concealment.

As discussed in section **b** hereof, (pp. 95-97, *supra*) the cause of action of each Respondent is barred by the applicable three year statute of limitations unless Respondents can depend on the federal doctrine of fraudulent concealment to toll the statute. In addition to the reasons set forth in section **c** hereof (pp. 98-109, *supra*), Petitioner contends that Respondents as a matter of law did not exercise due diligence in attempting to discover

the alleged fraud and for this additional reason cannot rely on the doctrine of fraudulent concealment to toll the statute.

In *Holmberg* v. *Armbrecht*, 327 U.S. 392, 397 (1946), this Court, citing language from its prior decision in *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 343 (1875), declared that a plaintiff may rely on the doctrine of fraudulent concealment only where the plaintiff "has been injured by fraud and *remains in ignorance of it without any fault or want of diligence. . .*" (Emphasis added). The obligation of the plaintiff, when relying on an allegation of fraud or of fraudulent concealment to avoid a statute of limitations, to be "without any fault or want of diligence" has been consistently read as being applicable in actions brought under Section 10(b) and Rule 10b-5. *See, e.g., Vanderboom* v. *Sexton*, 422 F.2d 1233, 1240 (8th Cir. 1970) (requiring "reasonable inquiry" on the part of the plaintiffs in the discovery of the fraud); *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912, 915-916 (9th Cir. 1971) (allowing extension of the statutory period only "for reasonable failure to discover the fraud"); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 128 (7th Cir. 1972) (permitting the statute to toll only as long as the plaintiff injured by fraud "remains in ignorance of it without any fault or want of diligence or care on his part").*

The burden of proving due diligence and want of fault lies with the plaintiff who is relying on the

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* Similarly, in the instant cases the Seventh Circuit held that the doctrine of fraudulent concealment will toll the statute of limitations "until the plaintiff has obtained knowledge of the fraud or in the exercise of due diligence should have obtained knowledge of the fraud." (Pet. for Cert. App. A 33a).

doctrine of fraudulent concealment to toll a statute of limitations. In *Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974), and antitrust action for damages and injunctive relief, the defendants, moving for summary judgment, contended that the plaintiff's actions were barred by the applicable statute of limitations. The Sixth Circuit, at 496 F.2d 234, affirmed the District Court's rejection of the plaintiff's contention that it could rely on the doctrine of fraudulent concealment to toll the statute of limitations, holding that the burden of proving "due diligence" lay with the plaintiff and that there was no evidence in the record supporting the plaintiff's claim:

> [T]he District Court, after examining the pleadings, briefs, and exhibits, correctly determined that [the plaintiff] had not alleged or demonstrated by affidavit or otherwise that it had exercised due diligence in attempting to discover the cause of action. At best, as the District Court stated, there was nothing more than ignorance on the part of [the plaintiff] of its rights. This alone is insufficient to overcome the limitations defense. Accordingly, [the plaintiff] cannot avoid the statute of limitations on the ground of the fraudulent concealment rule.

Although the doctrine of fraudulent concealment is the sole basis on which Respondents rely to prevent the bar of the statute of limitations, the affidavits and other materials submitted by Respondents in opposition to Petitioner's motion for summary judgment contain not one shred of evidence which tends to prove that any of Respondents were exercising due diligence but nevertheless failed to discover the alleged fraud of Nay prior

to the filing of their original complaints.* The Seventh Circuit's holding that "[w]hether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be decided at a trial" (Pet. for Cert. App. A 34a) is therefore totally unsupported by any affirmative evidence submitted by Respondents, the parties whose burden it was to prove "due diligence." Moreover, the holding of the Seventh Circuit that "due diligence" can be asserted by a plaintiff relying on the doctrine of fraudulent concealment in the absence of any supporting evidence is particularly anomalous in light of *Hupp* v. *Gray*, 500 F.2d 993 (7th Cir. 1974), a case decided by the same Court of Appeals during the same month as the instant cases. In *Hupp* v. *Gray, supra* at 996, the Court of Appeals affirmed dismissal of the plaintiff's complaint alleging violations of Section 10(b) and Rule 10b-5 on the theory that the action was barred by the statute of limitations because the plaintiff, who was relying on the doctrine of fraudulent concealment, failed to meet his burden of proving his reasonable care and diligence:

> In order to invoke this doctrine, however, the plaintiff must have remained ignorant of the fraud "without any fault or want of diligence or care on his part." *Bailey* v. *Glover*, 86 U.S. (21 Wall.) 342, 348, 22 L. Ed. 636 (1874). It is well established that a plaintiff

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* Respondents were put on notice by Petitioner's Answer to Respondents' First Amended Complaint that Petitioners would rely on the defense of the statute of limitations. (A. 25). Although Respondents had sufficient time for discovery thereafter and did in fact take copious depositions after Petitioner's motion for summary judgment was filed, Respondents failed to provide any evidence by affidavit or otherwise that they exercised diligence in attempting to discover Nay's fraud.

> may not merely rely on his own unawareness of the facts or law to toll the statute. *Morgan* v. *Koch*, 419 F.2d 993, 997 (7th Cir. 1969); *Laundry Equip. Sales Corp.* v. *Borg-Warner Corp.*, 334 F.2d 788, 792 (7th Cir. 1964). *The plaintiff, rather, has the burden of showing that he "exercised reasonable care and diligence in seeking to learn the facts which would disclose the fraud.* (Emphasis added).

Accordingly, the plaintiff was held barred by the statute of limitations because, although he alleged due diligence, neither his complaint nor his deposition "indicate by way of fleshing out the allegations of any actual steps he had taken. . . to discover the true facts." 500 F.2d at 996.

Similarly, the Respondents in these cases have failed either to allege or to assert by affidavits or otherwise any steps they took to discover Nay's fraud. For this reason, this Court should conclude as a matter of law that Respondents may not rely on the doctrine of fraudulent concealment and are therefore barred from their causes of action by the statute of limitations.

Not only did Respondents fail to meet their burden of proving due diligence, but Petitioner has submitted evidence, totally uncontroverted by Respondents, from which this Court can conclude as a matter of law that Respondents either knew, or should have known, that the spondents failed to make reasonable inquiry and consequently failed to exercise due diligence in attempting to discover the fraud allegedly committed by Nay.

The uncontroverted facts requiring the conclusion that Respondents either knew, or should have known, that the "escrow" investments were investments not through First Securities but through Nay and that Respondents should have reported this irregularity are many and are set forth in detail in the Statement of the Case (pp. 4-6,

supra), and are the same facts as those which relate to the doctrine of equitable estoppel. In summary, Respondents dealt exclusively with Nay and permitted Nay to deal with them entirely outside of the books and records of First Securities. They received no First Securities' confirmation of transactions forms, regular statements or annual audit confirmation requests which reflected their "escrow" investments, although they were accustomed to receive such documents with respect to their regular First Securities accounts. They paid for the "escrow" investments by checks which they drew to the order of Nay and not to First Securities. Nay gave Respondents handwritten receipts and sometimes his promissory note upon cash payment by Respondents of an "escrow" investment. Respondents received an inordinately high rate of interest on the "escrow" investments, Nay made the interest payments by his personal check and Respondents knew that Nay was deducting the interest payments from his personal income tax. Respondents' own correspondence indicates that they thought that the "escrow" investments were personal loans to Nay. Nay even indicated to Respondents that at his death his estate would be liable for the "escrow" investments.

These facts, totally uncontroverted by Respondents, compel the conclusion that as a matter of law Respondents knew, or should have known, that they were dealing with Nay in his individual capacity and not with First Securities. Respondents' negligent failure to report this knowledge to First Securities, Petitioner or any other authority requires the finding that Respondents failed as a matter of law to exercise due diligence in attempting to discover the fraud they are now alleging to have occurred.

Therefore, this Court should conclude as a matter of law that Respondents may not rely on the doctrine of

fraudulent concealment and are therefore barred from their causes of action by the statute of limitations.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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